A PRIMER ON

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Market Manipulation Regulations in the U.S. and U.K.

Exchange Act §§ 9(a), 10(b); SEC Rule 10b-5
Securities Act § 17(a)
Commodities Exchange Act §§ 4, 6 and 9

Art. 15 Market Abuse Regulation
§§ 89-91 Financial Services Act 2012
§ 2 Fraud Act 2006
Art. 5 REMIT

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I. Extraterritorial Application 41

"The methods and techniques of manipulation are limited only by the ingenuity of man. The aim must be therefore to discover whether conduct has been intentionally engaged in which has resulted in a price which does not reflect basic forces of supply and demand."

-- *Cargill v. Hardin*, 452 F.2d 1154, 1163 (8th Cir. 1971)

I. WHAT IS MARKET MANIPULATION?

Besides facilitating the transfer of stocks, currencies, futures, and other financial instruments between buyers and sellers, a basic function of financial markets is to allow participants to communicate information to one another about their subjective view of a particular instrument's price. If a trader is willing to place an actionable offer to buy a Treasury futures contract for $X, for example, she is implicitly signalling to the market that, in her view, the contract is worth approximately that amount (at least insofar as buying it at that level relates to her overall position and trading strategy).

By centrally aggregating the pricing opinions of many individual traders and investors, financial markets allow buyers and sellers to reach a rough consensus on an asset's current market value (*i.e.*, the approximate midpoint between supply and demand at any given moment). In this way, markets allow an asset's price to be "discovered" through the transmission of the prices at which various buyers and sellers are willing to transact which, in turn, presumably reflect the proprietary analyses of those buyers and sellers about an asset's value. As the US Supreme Court described this phenomenon, "[W]ell developed markets are efficient processors of public information. In such markets, the 'market price of shares' will 'reflect all publicly available information.'"[1] In other words, "The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings about a situation where the market price reflects as nearly as possible a just price."[2] For a market's price discovery mechanism to function properly, of course, investors must have faith in the integrity of the pricing information transmitted by their fellow market participants.[3]

Within this framework, market manipulation can be understood as any act which "obstructs the operation of the markets as indices of real value."[4] As two prominent law professors analysing the market activity that helped bring about the Great Depression put it:

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[1] *Amgen Inc. v. Conn. Ret. Plans & Tr. Funds*, 568 U.S. 455, 461 (2013).

[2] *Basic Inc. v. Levinson*, 485 U.S. 224, 246 (1988) (citing H.R. Rep. No. 1383, at 11).

[3] *See Schlanger v. Four-Phase Systems Inc.*, 555 F. Supp. 535, 538 (S.D.N.Y. 1982) ("It is hard to imagine that there ever is a buyer or seller who does not rely on market integrity. Who would knowingly roll the dice in a crooked crap game?"); *see also Basic*, 485 U.S. at 247 ("An investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price.")

[4] *Basic*, 485 U.S. at 246; *see also U.S. v. Socony-Vacuum Oil Co.*, 310 U.S. 150, 222-23 (1940) ("[M]arket manipulation in its various manifestations is implicitly an artificial stimulus applied to (or at times a break on) market prices, a force which distorts those prices, a factor which prevents the determination of those prices by free competition alone."); *Santa Fe Industries v. Green*, 430 U.S. 462 476 (1977) ("[M]anipulation is 'virtually a term of art when used in connection with securities markets" and "refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity."); *Gurary v. Winehouse*, 190 F.3d 37, 45 (2d Cir. 1999) ("The gravamen of manipulation is deception of investors into believing that prices at which they purchase and sell securities are determined by the natural interplay of supply and demand, not rigged by manipulators."); *In re Barclays Liquidity Cross & High Frequency Trading Litig.*, 126 F. Supp. 3d 342 (S.D.N.Y. 2015) (manipulation transmits "a false pricing signal to the market" that does not reflect the "natural interplay of supply and demand"); *Wilson v. Merrill Lynch & Co.*, 671 F.3d 120, 129-30 (2d Cir. 2011) (manipulation "connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities").

> "The term 'manipulation' may, in short, be applied to any practice which has as its purpose the deliberate raising, lowering or pegging of security prices. Buying and selling in themselves do, or course, affect price, but in a free and open market this is a natural consequence and not their pre-conceived purpose. Manipulation leads to an artificial and controlled price. Such a price, which is broadcast in the form of a market quotation, then, does not reflect an independent appraisal of the security in respect to the floating supply, nor to the immobile holdings throughout the country."[5]

Regulators and courts in the U.K. have described market manipulation as it is understood under English law as being comprised of three elements: (1) "financial dealings that provide fictitious indicators to obtain the price of a monetary tool at a synthetic level"; (2) "a series of contracts or orders to utilise fabricated devices or products;" (3) "sharing and dispersal of information that provides false or misleading signals."[6]

While these concepts are relatively easy to grasp in theory, market overseers have struggled to define exactly what separates lawful from unlawful market conduct. As such, the law relating to market manipulation has largely evolved on an ad hoc basis, with interpretations as to what is permissible and what is not changing over time. Because "[s]ophisticated economic justification for the distinctions made in this area of the law may at times seem questionable," observed the US Seventh Circuit, "Sometimes the 'know it when you see it' test may appear most useful."[7] The unpredictability of this subjective approach creates obvious problems for market participants. Complicating matters further is the fact that the means by which manipulation can be accomplished are getting more complicated. The increasing interconnectedness of global markets and the involvement of algorithmic traders expand the opportunities for market manipulation and makes detecting and investigating it more difficult. For example, many recent market enforcement actions have involved manipulation in one jurisdiction by persons physically located elsewhere, or transactions in one market designed to manipulate the prices in another.

As regulators try to keep pace with a moving target, financial institutions, traders, and investors risk having their strategies—even those that might be commonplace—called into question after the fact. One need look no further than the recent FX, Libor, and spoofing prosecutions for examples of market participants being selectively penalized for engaging in widespread, ostensibly accepted market practices. To prepare for possible regulatory scrutiny, it is essential for traders, compliance professionals, and defense counsel to remain current on the regulatory frameworks applicable in each of the jurisdictions in which they, or their companies and clients, are active. The purpose of this primer is to provide an overview of the market manipulation regulations in two of the world's largest and most active markets: the United States and United Kingdom.

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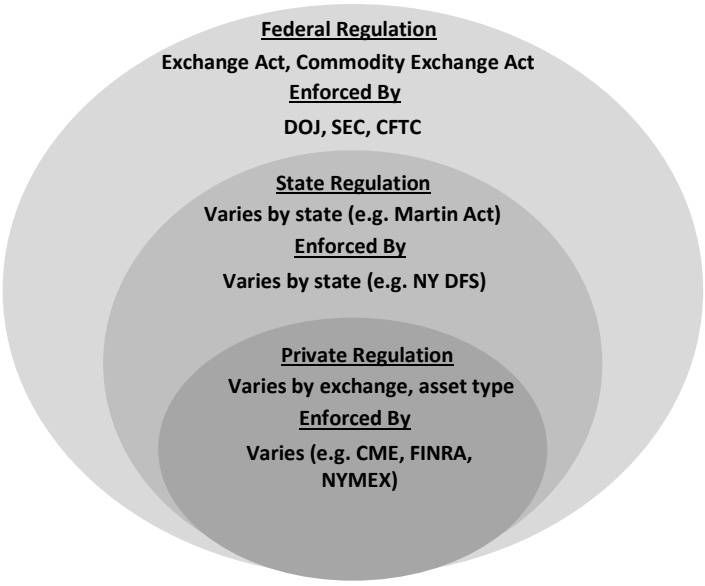
[5] James Wm. Moore and Frank M. Wiseman, *Market Manipulation and the Exchange Act*, 2 U. CHI. L. REV. 46 (1934-1935).
[6] Ester Herlin-Karnell and Nicholas Ryder, *Market Manipulation and Insider Trading* (New York: Hart Publishing, 2019), at 2.
[7] *Frey v. CFTC*, 931 F.2d 1171, 1175 (7th Cir. 1991).

II. MARKET MANIPULATION UNDER U.S. FEDERAL LAW

At the federal level, the key market manipulation regulations are in the 1933 Securities Act, 1934 Exchange Act, 1936 Commodity Exchange Act, and Title 18 of the U.S. Code. While this primer does not address them, each of the states has its own set of laws that can also reach manipulation and fraud in financial markets (*e.g.*, New York State's Martin Act). There are also various private companies (*e.g.,* FINRA, NYMEX, CME, ICE) that independently police behaviour on the markets they control through their own rules and procedures. Depending on the type of trading at issue in any given case, the overlapping regulations from each of these different sources may need to be considered.

Indeed, manipulation investigations often begin at the private level. For example, the CME Group, which runs the world's largest futures exchange, has its own team of in-house investigators who pore over trade data for signs of misconduct. When something raises a red flag, investigators will generally solicit an explanation from the trader responsible. If that explanation is insufficient, the CME has the option to impose its own sanctions and/or refer the matter to federal law enforcement for further scrutiny.

The serial investigations into Michael Coscia, the first person to be criminally charged with "spoofing," followed this exact sequence. After Coscia settled enforcement actions brought by the CME and ICE (two private exchange operators), Coscia was sued by the CFTC. In July 2013, Coscia reached a settlement with the CFTC requiring him to pay over $4.5 million in financial penalties and serve a one-year suspension from trading. A year later, he was indicted by the DOJ for the same conduct. At trial, Coscia's representations to the other regulators—and especially his CFTC deposition testimony—were used as key pieces of evidence against him. He was eventually found guilty and sentenced to three years in federal prison.[8]



[8] Walter Pavlo, "After Conviction on 'Spoofing,' Defendant Questions His Previous Counsel's Representation," FORBES (Nov. 20, 2019).

A. Structure of U.S. Federal Market Regulators

Remit: criminal enforcement of all US federal laws
Jurisdiction: global[9]
Financial Instruments Covered: all
Investigatory Arm: Federal Bureau of Investigation (FBI)

Remit: civil enforcement of Securities Act and Exchange Act
Jurisdiction: global
Financial Instruments Covered: OTC and exchange-traded "securities" (*e.g.*, stocks, bonds); cryptocurrencies
Investigatory Arm: Division of Enforcement

Remit: civil enforcement of Commodity Exchange Act
Jurisdiction: global
Financial Instruments Covered: OTC and exchange-traded commodities and derivatives (*e.g.*, futures, swaps, options); cryptocurrencies
Investigatory Arm: Division of Enforcement

B. 1934 Exchange Act

Following Wall Street's stock market crash in October 1929 and the ensuing global economic meltdown, Congress realised that economic recovery necessitated restoration of public faith in the securities markets. As legal commentators noted at the time, "It was inevitable that some type of measure should be taken to correct the evils of over-speculation and financial racketeering occurring on organized security exchanges, and to prevent as far as possible another major stock market crash with its attendant grief and destruction."[10]

To this end, two major pieces of federal legislation were passed during the height of the Great Depression in the early 1930s: the Securities Act of 1933 and the Securities Exchange Act of 1934.[11] The '33 Act has relatively limited scope in that it deals primarily with the process by which companies can register, market, and issue new securities.[12] The '34 Act, on the other hand, was designed to broadly

[9] US law enforcement's expansive interpretation of its jurisdiction is discussed below in Section II.F.
[10] Moore & Wiseman, *supra*, p. 46.
[11] *See* https://www.sec.gov/Article/whatwedo.html.
[12] Larry Bumgardner, "A Brief History of the 1930s Securities Laws in the United States – And Potential Lessons for Today," *available at* http://www.jgbm.org/page/5%20Larry%20Bumgardner.pdf.

regulate the purchase or sale of securities[13] on secondary U.S. markets. In other words, the statute focuses on what happens *after* a security's initial issuance. In addition to creating a civil securities regulator, the SEC, the '34 Act made it unlawful for anyone involved in the securities industry—investors, brokers, dealers, and traders—to act dishonestly. As stated in the '34 Act's introductory section, the law was intended to be a comprehensive legal framework for essentially all securities transactions in the U.S.:

> "[T]ransactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are effected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, including . . . requirements necessary to make such regulation and control reasonably complete and effective, in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Federal Reserve System, and to insure the maintenance of fair and honest markets in such transactions."[14]

With respect to market manipulation, the key provisions of the '34 Act are Section 9(a) and Section 10(b). There are a range of potential penalties that can be applied to violations of these provisions. The SEC can, for example, seek injunctive relief and civil monetary penalties in federal court or through its own administrative procedures.[15] Criminal penalties can be imposed by the DOJ for "willful" '34 Act violations.[16] Individuals found guilty of a criminal market manipulation offense under the '34 Act are subject to a maximum of 20 years in prison and fines of up to $5 million.[17]

1. <u>Section 9(a) (15 U.S.C. § 78i(a)) – Prohibition Against Manipulation of Security Prices</u>

Section 9(a) was designed by Congress to "prevent rigging of the market and to permit operation of the natural law of supply and demand."[18] What exactly constitutes "the natural law of supply and demand" has never been definitively pinned down by the courts, but, broadly speaking, Section 9(a) makes it unlawful to:

(1) Create "a false or misleading appearance of active trading in any security other than a government security, or a false or misleading appearance with respect to the market for any such security" through wash sales or matched orders;

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[13] The term "security" is broadly defined in § 3(a)(10) of the Exchange Act and includes stocks, bonds, and "the many types of instruments that in our commercial world fall within the ordinary concept of a security." *Marine Bank v. Webster*, 455 U.S. 551, 555-56 (1982). The statutory definition excludes only currencies and notes with a maturity of less than nine months. Whether or not uncommon types of financial instruments qualify as a "security" is often a hotly contested issue in regulatory proceedings. The applicable test was created by the Supreme Court in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). The *Howey* test requires "a contract, transaction or scheme" whereby (1) a person invests money, (2) in a common enterprise and, (3) is led to expect profits (4) solely from the efforts of the promoter or a third party.

[14] 15 U.S.C. § 78b.

[15] 15 U.S.C. § 78u(d).

[16] 15 U.S.C. § 78ff.

[17] 15 U.S.S. § 78ff(a).

[18] *United States v. Stein*, 456 F.2d 844, 850 (2d Cir. 1972); *Trane Co. v. O'Connor Secs.*, 561 F. Supp. 301, 304 (S.D.N.Y. 1983) ("The central purpose of section 9(a) is not to prohibit market transactions which may raise or lower the price of securities, but to keep an open and free market where the natural forces of supply and demand determine a security's price.").

(2) Engage in a series of transactions that creates "actual or apparent active trading" or raises or depresses prices "for the purpose of inducing the purchase or sale" of a security by others; or

(3) Knowingly spread false information about a security in order raise or depress its price and thereby induce the purchase or sale of a security by another.

a. "Matched Orders" and "Wash Sales" under Exchange Act § 9(a)(1)

Matched orders and wash sales are two of the most basic means of manipulating the market, and they are explicitly prohibited by Exchange Act § 9(a)(1). In these transactions, a manipulator acts as both the buyer and the seller in order to give the false appearance of arms'-length trades without assuming any actual risk.[19] Alternatively, the manipulator can act in concert with other conspirators to give the false appearance that trades are disinterested transactions between independent actors.[20]

In order to establish a § 9(a)(1) violation, regulators must prove the "existence of (1) a wash sale or matched orders in a security, (2) done with scienter, and (3) for the purpose of creating a false or misleading appearance of active trading in that security . . . ."[21] Certain courts have held that when wash sales/matched orders are shown to have been done intentionally (*i.e.* not by mistake), manipulative intent can be inferred.[22]

One of the more notable "matched trading" cases in recent years was the 2015 parallel DOJ/SEC action against Benjamin Wey, CEO of New York Global Group, a private equity firm. The authorities alleged that Wey secretly obtained shares of one of his firm's clients (CleanTech) through foreign nominees and then sought to sell those shares through prearranged transactions at inflated values.[23] He then purportedly talked up the stock to other investors to increase its price further before dumping it for a large profit. Yet, in a fortunate twist for Wey, the criminal case against him was ultimately dismissed after SDNY Judge Nathan took the extraordinary step of suppressing all of the evidence obtained during the FBI's execution of search warrants on Wey's office and apartment. In a lengthy opinion examining the Fourth Amendment's particularity requirements, Judge Nathan concluded that the warrants were deficient because: (1) they lacked particularity; (2) were overbroad; and (3) were not saved by the good-faith exception to the exclusionary rule.

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[19] *See, e.g.*, *United States v. DiScala*, 14-cr-399, at *6 n.10 (E.D.N.Y. Feb. 27, 2018) (defining wash sale as "a sale of stock where there is no change in beneficial ownership"); *SEC v. U.S. Envtl. Inc.*, 155 F.3d 107, 109 (2d Cir. 1998) (matched orders are "orders for the purchase or sale of a security that are entered with the knowledge that orders of substantially the same size, at substantially the same time and price, have been or will be entered by the same or different persons for the sale/purchase of such security").

[20] *See, e.g.*, *United States v. Scop*, 846 F.2d 135, 137 (2d Cir. 1988) (discussing matched orders using fictitious nominees); *SEC v. Wilson*, 04-cv-01331, 2009 WL 2381954, at *1 (D. Conn. July 31, 2009) (A matched order occurs "when an individual enters an order or orders for the purchase or sale of a security registered on a national securities exchange with the knowledge that an order of substantially the same size, at substantially the same time and at substantially the same price, for the sale or purchase of such security, has been or will be entered by or for the same or different parties.").

[21] *SEC v. Malenfant*, 784 F. Supp. 141, 145 (S.D.N.Y. 1992).

[22] *See, e.g.*, *SEC v. Masri*, 523 F. Supp. 2d 361, 365-75 (S.D.N.Y. 2007) ("Such conduct, closely resembling fraud, is patently manipulative, serving no purpose other than to transmit false information to the market and artificially affect prices. The defendant's manipulative intent can be inferred from the conduct itself.")

[23] *United States v. Wey*, 15-cr-00611, at *2 (S.D.N.Y. Jun. 13, 2017).

After the DOJ terminated its case against Wey, the SEC dismissed their parallel claims and issued a press release acknowledging that it "had relied on evidence that was later suppressed in a parallel criminal proceeding and determined that its ability to rely on the suppressed evidence may also be affected."[24]

b. "Marking the Close" and "Painting the Tape" under Exchange Act § 9(a)(2)

The price of most publicly traded securities and derivatives fluctuate throughout each trading day. The two prices that are given most attention by investors are the opening price and the closing price. The closing price is particularly significant because it is the primary reference point for determining an asset's performance over a given time period.

Because of this, the securities laws include specific prohibitions on activity—variously referred to as "marking the close," "banging the close," or "painting the tape"—meant to artificially affect prices or trading activity in the time period just before market close. "[M]arking the close . . . is a form of market manipulation that involve[s] attempting to influence the closing price of a publicly traded share by executing purchase or sale orders at or near the close of normal trading hours. Such activity can artificially inflate or depress the closing price for that security and can affect the price of the market on close orders, which are orders submitted to purchase shares at or near as possible to the closing price."[25]

The purpose of marking the close is to influence the trading decisions of other market participants by creating "actual or apparent active trading in such security."[26] Note that although the § 9(a)(2) refers only to "transactions," courts have held that this term includes not only completed purchases or sales but also bids and offers to purchase or sell securities.[27] The SEC has taken the same position.[28] This expansive interpretation allows regulators to sanction traders for manipulation even when they have not actually consummated a transaction. The criteria used to differentiate legal bids

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[24] *See* https://www.sec.gov/litigation/litreleases/2018/lr24105.htm. Other recent cases involving alleged violations of § 9(a)(1) include: *United States v. Durante*, 15-cr-00171 (S.D.N.Y.); *United States v. Tuzman*, 15-cr-00536 (S.D.N.Y.); *United States v. Galanis*, 15-cr-00641 (S.D.N.Y.).

[25] *United States v. Georgiou*, 742 F. Supp. 2d 613, 624 (E.D. Pa. 2010); *see also Markowski v. SEC*, 274 F.3d 525, 529 (D.C. Cir. 2001) (concluding that § 9(a)(2) makes it unlawful to affect a series of transactions in any security creating actual or apparent active trading in such security or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others); *Hunter v. FERC*, 711 F.3d 155, 156 (D.C. Cir. 2013) ("Marking the close is investor argot for buying or selling stock as the trading day ends to artificially inflate the stock's value.").

[26] *See SEC v. Masri*, 523 F. Supp. 2d 361, 366 (S.D.N.Y. 2007) (Section 9(a)(2) "broadly prohibits securities transactions that create actual or apparent active trading in such security, or raise or depress the price of such security, for the purpose of inducing the purchase or sale of such security by others"); *SEC v. Schiffer*, 1998 WL 307375, at *6 (S.D.N.Y. June 11, 1998) (finding that unlawful marking the close takes place when an individual engages in a series of late day transactions that create 'that create actual or apparent active trading in such security, or raise or depress the price of such security, for the purpose of inducing the purchase or sale of such security by others'"); *SEC v. Kwak*, 04-cv-01331 (D. Conn. Feb. 12, 2008) (court denying defendants' motion for directed verdict after concluding that evidence of concentrated late day trades made "with the goal of showing either artificial upward movement in the stock price, or at least preventing downward movement" sufficient to establish § 9(a)(2) violation).

[27] *See, e.g., SEC v. Lek Sec. Corp.*, 276 F. Supp. 3d 49, 62 (S.D.N.Y. 2017); *SEC v. Malenfant*, 784 F. Supp. 141, 145 (S.D.N.Y. 1992); *Spicer v. Chicago Bd. Options Exch. Inc.*, 1990 WL 172712, at *2 (N.D. Ill. Oct. 30, 1990).

[28] *See, e.g., In the Matter of Biremis,* 105 SEC 862, 2012 WL 6587520, at *2 (Dec. 18, 2012). Placing bids has also been determined to fall within the CEA's definition of "transaction." *See United States v. Radley*, 632 F.3d 177, 179-85 (5th Cir. 2011) ("Appellees' bidding activities fall within the ordinary meaning of 'transaction,' as well as the CEA's internal definition. . . . The CEA includes conduct 'commonly known to the trade as . . . [a] 'bid' or 'offer' within the scope of a transaction.") (citing 7 U.S.C. § 2(a)(1)(A)).

and offers and those that "paint the tape" is unclear, but the SEC will often focus on situations involving rapidly placed orders near the top of the order book (or at staggered price levels).[29]

c. Pump and Dump Schemes

So-called "pump and dump" schemes are a relatively unsophisticated form of market manipulation involving three basic steps: (1) large purchases of a particular stock (usually ones that are thinly traded and/or have low market capitalisation); (2) "pumping up" of the asset's price by the promoter through a fraudulent sales campaign based on misinformation; and (3) dumping of the asset back into the market by the promoter at an inflated price.[30] But regulators have also brought pump and dump charges against defendants engaging in more complicated manipulative practices.

In *SEC v. Diversified Corp.*, for example, a major holder of a thinly traded, over-the-counter stock sought to inflate the price of his shares.[31] Rather than follow the typical pump and dump playbook, the stockholder conspired with the company's board to first authorize the issuance of millions of facially unrestricted shares. He then instructed that these shares be issued to several other individuals, who were in on the scheme. Next, he "pumped up" the share price by raising his bid price for shares to indicate that there was a demand for the stock at higher prices—"even when it was higher than the bid price announced by other market makers and there was no demand for the stock." According to the SEC, this practice "distorted the market" because he was essentially bidding against himself and was thereby sending a false signal to investors—"false in the sense that he was not raising his bid to meet a genuine demand for [the company's] shares." *Id.* To further inflate the stock price, the defendant and his co-conspirators also issued press releases that falsely portrayed the stock as a good investment. After the stock had increased by over 2000% within a few months, the shares were dumped on the market.

This method of manipulation has often been employed at boiler room-type operations involving high pressure sales calls placed to vulnerable victims.[32] It can also be done electronically via "cyber" boiler rooms:

> "The new 'cyber' boiler rooms allow scam artists to conduct sophisticated market manipulations at almost no cost over the Internet from the comfort of their own homes. In four easy steps, a manipulator can consummate the entire fraud. The first step is to set up a site or home page where potential investors can find out about the issuer. In step two, the manipulator, using bulk e-mail or a spamming program, personally contacts potential investors regarding an investment opportunity. In step three, the manipulator begins a 'buzz' about the issuer and its shares by posting false information to bulletin boards, newsgroups, and discussion forums. Finally, in step four, the manipulator strengthens the buzz by employing an Internet investment newsletter. It is that easy to hype the stock, and

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[29] *SEC v. Fiore*, 416 F. Supp. 3d 306, 316 (S.D.N.Y. 2019).

[30] *See United States v. Downing*, 297 F.3d 52, 55-56 (2d Cir. 2002) (A pump and dump scheme "denotes a stock-market manipulation scheme in which 'the schemers [first] artificially inflate, or 'pump' the price of a stock by bribing stock promoters to sell it, and [then] 'dump' the stock once the price [becomes] sufficiently high."); Markham, *supra*, p. 259 (collecting pump and dump cases).

[31] 378 F.3d 1219, 1222-23 (11th Cir. 2004).

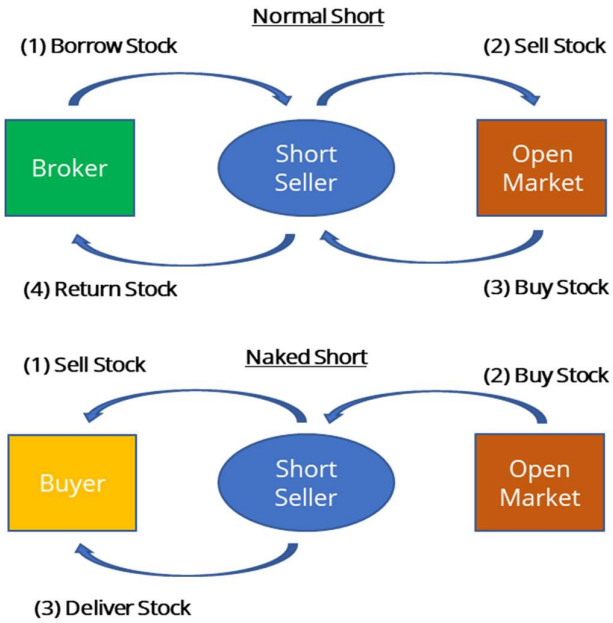
[32] Jerry W. Markham, *A Financial History of Modern U.S. Corporate Scandals, From Enron to Reform*, 27-28 (2005).

easier still to sell the stock back into the exchanges or over-the-counter markets at a profit and reap the financial rewards of having inflated the stock price."[33]

d. Naked Short Selling

By "short selling" a stock or other instrument, trader's are able to make a bet that its price will decline. A short sale transaction typically takes place in three stages: first, the short seller borrows the security from a third-party and promises to return it at an agreed-upon date; second, the short seller sells the borrowed security in the market; third, at or around the date the short seller needs to return the security to the lender, she buys it back from the market; and lastly, it is returned to the lender. In a successful short sale, the price at which the short seller buys the security back in step three is less than the price it was sold for in step two (with the short seller pocketing the difference).[34]

"Naked" short selling is when a seller sells a security without first borrowing it in the hopes that it can be bought for less than the sale price before it must be delivered to the buyer, which is generally a matter of days. If the seller fails to do so, they will generally be liable for a "failure to deliver" and be forced to pay the purchaser cash compensation. Naked short selling is not illegal *per se*, but the practice is subject to heavy regulation by the SEC because it can be used to improperly drive down a stock's market price.[35] Although various attempts have been made to characterize naked short selling as inherently manipulative, such efforts have largely failed. Rather, courts have determined that naked short selling are is only unlawful when combined with some other manipulative act.



[33] Nancy Toross, *Double-Click on This: Keeping Pace with On-Line Market Manipulation*, 32 LOY. L.A. L. REV. 1399, 1420-1421 (1999).
[34] *See* 17 C.F.R. § 240.3b-3 (defining a short sale).
[35] *See* SEC, "Key Points About Regulation SHO," *available at* https://www.sec.gov/investor/pubs/regsho.htm.

As the Seventh Circuit stated in *ATSI Comm., Inc. v. Shaar Fund, Ltd.*, 493 F.3d 87, 99-105 (2d Cir. 2007), "[S]hort selling—even in high volumes—is not, by itself, manipulative. Aside from providing market liquidity, short selling enhances pricing efficiency by helping to move prices of overvalued securities toward their intrinsic values. In essence, taking a short position is no different than taking a long position. To be actionable as a manipulative act, short selling must be willfully combined with something more to create a false impression of how market participants value a security."

No precise definition has been given to exactly what the "something more" must be, but caselaw suggests that in order to be manipulative, short selling must be combined with some sort of misinformation transmitted to the market.[36]

2. Section 10(b) (15 U.S.C. § 78j) – Regulation of the Use of Manipulative and Deceptive Devices

Section 10(b) makes it unlawful to "use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." Through this loosely worded provision, Congress granted the SEC broad powers "to combat manipulative abuses in whatever form they might take, including anti-fraud, prophylactic, and general rulemaking authority."[37]

Eight years after the passage of the '34 Act, the SEC adopted Rule 10b-5 (17 C.F.R. § 240.10b-5) to refine Section 10(b)'s prohibitions. As stated in an accompanying SEC press release, Rule 10b-5 was designed to "close a loophole in the protections against fraud administered by the [SEC] by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase."[38] As interpreted by the Supreme Court, 10b-5 fits within Section 10(b) such that "Rule 10b-5 encompasses

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[36] *See, e.g.*, *GFL Advantage Fund, Ltd. v. Colkitt*, 272 F.3d 189, 205 (3d Cir. 2001) ("Regardless of whether market manipulation is achieved through deceptive trading activities or deceptive statements . . ., it is clear that the essential element of the claim is that *inaccurate* information is being injected into the marketplace.") (citing *In re Olympia Brewing Co. Sec. Litigation*, 613 F. Supp. 1286, 1292 (N.D. Ill. 1985)); *Cohen v. Stevanovic*, 722 F. Supp. 2d 416, 424-25 (S.D.N.Y. 2010) ("Plaintiffs' broad and conclusory allegations of naked short selling do not state a claim for market manipulation. The [complaint] . . . does not asset that the parties to the alleged short sales were anything other than bona fide buyers and sellers trading at the reported price of the transaction. The fact that the seller was allegedly unable to deliver the security on the settlement date-three days after the transaction – does not transform that legitimate sale into unlawful market manipulation. Even when the seller is unable to deliver the stock on the settlement date, both parties obtain contractual settlement and still bear the market risk of the transaction. . . . As a result, allegations of failures to deliver, without more, are insufficient to state a claim for market manipulation. Instead, 'to be actionable as a manipulative act, short selling must be willfully combined with something more to create a false impression of how market participants value a security.'").

[37] Melissa W. Palombo, *The Short-Changing of Investors: Why a Short Sale Price Test Rule Is Necessary in Today's Markets*, 75 Brooklyn L. Rev. 1447, 1488 (2010); *see also Chiarella v. United States*, 445 U.S. 222, 226 (1980) ("Section 10(b) was designed as a catchall clause to prevent fraudulent practices."); *SEC v. Zandford*, 535 U.S. 813, 819 (2002) (deciding that the statute should be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes").

[38] SEC Release No. 3230 (May 21, 1942); *see also Chadbourne & Parke LLP v. Troice*, 571 U.S. 377, 390 (2014) (purpose of Rule 10b-5 is "to insure honest securities markets and thereby promote investor confidence"); *Basic*, 485 U.S. at 230 (Rule 10b-5 intended to "protect investors against manipulation of stock prices" and rein in "dishonest practices of the market place that thrive upon mystery and secrecy").

only conduct already prohibited by § 10(b)."[39] Although Rule 10b-5 was adopted with little fanfare, it has become one of the best-known provisions in American law.[40] The rule makes it "unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

> (a) to employ any device, scheme, or artifice to defraud,
>
> (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
>
> (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

Unlike the § 9 prohibitions which target specific types of trading activity, §10b and Rule 10b-5 were intended to be catchall measures to cover a broad spectrum of imprecisely-defined misconduct. By keeping their contours somewhat fuzzy, Congress and the SEC designed the regulations to be adaptable enough to "reach the unanticipated schemes of clever" market participants.[41]

Thus, although § 10(b) and Rule 10b-5 only prohibit "conduct involving manipulation or deception," the means by which such manipulation or deception are accomplished are essentially irrelevant insofar as the regulations' scope is concerned. Rather, what matters is the intent behind the market conduct at issue.[42] Further, the Supreme Court has held that "[c]onduct itself can be deceptive," and so liability under § 10(b) and Rule 10b-5 does not necessarily require "a specific oral or written statement."[43]

a. <u>Market Manipulation Under § 10(b) and Rule 10b-5</u>

While the prohibitions contained in § 10(b) and Rule 10b-5 are broader than those in § 9,[44] the statutes overlap, and conduct that violates § 9 may also violate § 10(b) and Rule 10b-5 if done with

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[39] *Stoneridge Investment Parnters, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 157 (2008); *see also United States v. O'Hagan*, 521 U.S. 642, 651 (1997) ("Liability under Rule 10b-5, our precedent indicates, does not extend beyond conduct encompassed by §10(b)'s prohibition.").

[40] Steve Thel, *Taking Section 10(b) Seriously: Criminal Enforcement of SEC Rules*, 2014 COLUM. BUS. L. REV. 1 (2014).

[41] Daniel J. Bacastow, *Due Process and Criminal Penalties under Rule 10b-5*, 73 JOURNAL OF CRIM. LAW AND CRIMINOLOGY 96, 96 (Spring 1982); *see also Sante Fe Industries*, 430 U.S. at 477 (with § 10(b), "Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices"); *Superintendent of Insurance of the State of New York v. Bankers Life and Casualty Company*, 404 U.S. 6, 11 n. 7 (1971) ("We believe that §10(b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden variety type of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws.").

[42] *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 177 (1994) (§ 10(b) prohibits not only material misstatements but manipulative acts of any kind); *United States v. Royer*, 549 F.3d 886, 900 (2d Cir. 2008) (observing that the "broad language" of Section 10(b), "on its face, extends to manipulation of all kinds, whether by making false statements or otherwise"); *Catton v. Defense Tech. Sys. Inc.*, 05-cv-06954, 2006 WL 27470, at *6 (S.D.N.Y. Jan. 3, 2006) ("[W]hile misrepresentations affect investor beliefs by directly injecting false information into the marketplace, market manipulation affects beliefs indirectly by creating circumstantial evidence that positive information has entered the market.").

[43] *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 128 S.Ct. 761, 769 (2008); *United States v. Finnerty*, 533 F.3d 143, 151 (2d Cir. 2008) (§ 10(b) requires proof of "manipulation or a false statement, breach of a duty to disclose, or deceptive communicative conduct").

[44] *In re Lernout Hauspie Sec. Litig.*, 236 F. Supp. 2d 161, 170 (D. Mass. 2003) ("[T]he Supreme Court has stressed that . . . the term 'manipulative' does not limit § 10(b)'s coverage to traditional securities schemes such as wash sales or matched orders; to the

"scienter."[45] The Supreme Court defines "scienter" as "a mental state embracing intent to deceive, manipulate, or defraud."[46] In most Circuits, reckless conduct—*i.e.* "conduct which is highly unreasonable and which represents an extreme departure from the standards of ordinary care"—satisfies the scienter requirement.[47] Because of the focus on scienter, § 10(b) and Rule 10b-5 can arguably be violated based on the defendant's intent alone.[48] That is, an otherwise legal transaction can be treated as illegal if it was motivated by criminal intent.

This is in contrast with § 9 violations, where there must be evidence that a defendant's actions fell into certain categories or affected the market in specific ways.[49] Manipulation under § 10(b) and Rule 10b-5 therefore "connotes intentional or wilful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities." But since virtually all market activity affects prices in some way, the "critical question then becomes what activity 'artificially' affects a security's price in a deceptive manner."[50] The majority approach requires a showing that an alleged manipulator engaged in market activity aimed at deceiving investors into believing "that prices at which they purchase and sell securities are determined by the natural interplay of supply and demand, not rigged by manipulators."[51]

To identify "activity that is outside the 'natural interplay of supply and demand,' courts generally ask whether a transaction sends a false pricing signal to the market. For example, the Seventh Circuit recognizes that one of the fundamental goals of the federal securities laws is "to prevent practices that impair the function of stock markets in enabling people to buy and sell securities at prices that reflect

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contrary, 'Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices.'") (quoting *Ernst Ernst*, 425 U.S. at 1999); *Bankers Life*, 404 U.S. at 11, n. 7 ("We believe that § 10(b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden variety type of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws.").

[45] *See Aaron v. SEC*, 446 U.S. 680, 691, 697 (1980) (to prove a § 10(b) violation, SEC must show that defendants (1) used the instrumentalities of interstate commerce to engage in conduct designed to deceive or defraud investors and (2) acted with scienter); *SEC v. U.S. Envtl., Inc.*, 155 F.3d 107, 111 (2d Cir. 1998); *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787, 795-96 (2d Cir. 1969) (explaining that failure to disclose a manipulation operates as a fraud or deceit on other investors).

[46] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n. 12 (1976).

[47] *See, e.g.*, *SEC v. Obus*, 693 F.3d 276, 286 (2d Cir. 2012).

[48] *See Santa Fe*, 430 U.S. at 476 (to prove a manipulation claim under § 10(b), plaintiffs need only identify a manipulative act intended to mislead investors by artificially affecting market activity); *Koch v. SEC*, 793 F.3d 147, 153-5 (D.C. Cir. 2015) ("[I]ntent—not success—is all that must accompany manipulative conduct to prove a violation of the Exchange Act and its implementing regulations."); *SEC v. Lek Sec. Corp.*, 276 F. Supp. 3d 49, 60 (S.D.N.Y. 2017) (noting that "manipulative conduct need [not] be successful in order to violate the securities laws); *SEC v. Cavanagh*, 2014 WL 1594818, at *25 (S.D.N.Y. July 16, 2004), *aff'd*, 445 F.3d 105 (2d Cir. 2006) (SEC need only allege facts to establish "that defendants . . . engaged in conduct designed to deceive or to defraud investors, and . . . that defendants acted with scienter").

[49] *See SEC v. Fiore*, 416 F. Supp. 3d 306, 325-27 (S.D.N.Y. 2019) (noting that § 9(a)(1) "explicitly forbids several common types of market manipulation . . . that involve fictitious transactions and do not result in any change in beneficial ownership," while § 9(a)(2) "more broadly prohibits securities transactions that create actual or apparent active trading in such security, or raise or depress the price of such security, for the purpose of inducing the purchase or sale of such security by others") (citing *SEC v. Masri*, 523 F. Supp. 2d 361, 366 (S.D.N.Y. 2007); *Schiffer*, 1998 WL 307375, at *6 ("[U]nder Section 9(a) of the Exchange Act, when a series of transactions that have raised or depressed a stock price (or have created actual or apparent sales volume) is carried out for the purpose of inducing others to buy or sell that stock, a market manipulation has occurred.").

[50] *ATSI*, 493 F.3d at 99-100.

[51] *Gurary*, 190 F.3d at 45; *see also Mobil Corp. v. Marathon Oil Co.*, 669 F.2d 66, 374 (6th Cir. 1981) (manipulation under § 10(b) refers to "means unrelated to the natural forces of supply and demand"); *Crane Co.*, 419 F.2d at 796 (Rule 10b-5 violated by "distorting the market picture").

undistorted (though not necessarily accurate) estimates of the underlying economic value of the securities traded, and thus looks to the charged activity's effect on capital market efficiency."[52] To prevent this "deleterious effect" on the capital markets, certain courts have distinguished manipulative from legal conduct by asking whether the manipulator "inject[ed] inaccurate information into the marketplace or creat[ed] a false impression of supply and demand for the security . . . for the purpose of artificially depressing or inflating the price of the security."[53]

This approach has not been universally accepted, however, and a key issue that is as yet unresolved by the Supreme Court is whether manipulative intent alone is enough to make so-called "open market" transactions manipulative and in violation of the securities laws (as discussed in the next section).

b. <u>A Safe Harbor for "Open Market" Transactions?</u>

Manipulative conduct is generally characterized as either "traditional manipulation" or "open market manipulation." Traditional manipulation involves one of the specifically prohibited trading practices listed in Exchange Act § 9(a)(1) or some type of explicitly fraudulent conduct under § 10(b). In open market manipulation, the trading activity is not objectively fraudulent, but may nevertheless constitute illegal manipulation when taken in context. In other words, open market transactions are ones that are facially legitimate in all respects—"the transaction is real, . . . beneficial ownership is changing, and the volume of trading is reflective of market activity."[54] "The difficulty in such cases, where the activity in question is not expressly prohibited, is to 'distinguish between legitimate trading strategies intended to anticipate and respond to prevailing market forces and those designed to manipulate prices and deceive purchasers and sellers.'"[55]

In *GFL Advantage*, the Third Circuit was reluctant to find that otherwise legal conduct could violate securities laws based only on manipulative intent. Rather, it determined that the law required evidence of certain types of activity in addition to malintent—*e.g.* unauthorized placements and parking of stock, secret sales without disclosing the real party in interest, guaranteeing profits to encourage short selling by others, fraudulently low appraisals, painting the tape.[56] This determination "may be explained by the fact that it is unusual in American law to impose liability based solely on the intent of the actor. There may also be a concern that because of the ambiguity and difficult in establishing intent,

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[52] *ATSI*, 493 F.3d at 99-100 (citing *Sullivan Long, Inc. v. Scattered Corp.*, 47 F.3d 857, 861 (7th Cir.1995)); *see also SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1466 (2d Cir. 1996) (§10(b) seeks a market where "competing judgments of buyers and sellers as to the fair price of the security brings about a situation where the market price reflects as nearly as possible a just price"); *In re Initial Pub. Offering Sec. Litig.*, 383 F. Supp. 2d 566, 579 (S.D.N.Y. 2005) (in an efficient market, trading engineered to stimulate demand can mislead investors into believing that the market has discovered some positive news and seeks to exploit it).
[53] *GFL Advantage Fund, Ltd. v. Colkitt*, 272 F.3d 189, 207 (3d Cir. 2001).
[54] *SEC v. Masri*, 523 F. Supp. 2d 361, 365 (S.D.N.Y. 2007).
[55] *Id.* (quoting *GFL Advantage*, 272 F.3d at 205).
[56] *GFL Advantage*, 272 F.3d at 205.

prohibition of otherwise legal conduct based only on an actor's intent might chill and deter socially desirable conduct."[57]

In contrast, the D.C. Circuit accepted that open-market transactions can constitute market manipulation if done with manipulative intent. In *Markowski v. SEC*, for example, "defendants argued that they could not be convicted of market manipulation based on otherwise legal transactions involving '(1) maintaining high bid prices . . . and (2) absorbing all unwanted securities into inventory' because their bids and trades were 'real.'"[58] In rejecting this argument, the D.C. Circuit cited "Congress's determination that 'manipulation' can be illegal solely because of the actor's purpose."[59]

In New York's Second Circuit, the law on open-market manipulation is not yet settled.[60] But in *United States v. Mulheren*, the Second Circuit suggested in dicta that a trader could be convicted of market manipulation for an open market transaction where the sole intent of such transaction was to artificially affect the price of a security.[61] Lower courts in the Second Circuit have generally followed the reasoning in *Mulheren* and rejected the approach in *GFL Advantage*.[62]

c. <u>Layering/Spoofing Under § 10(b) and Rule 10b-5</u>

While spoofing in the commodities markets was explicitly made illegal in the CEA following the enactment of Dodd-Frank (see Section D.2 below), the same conduct in other markets is prohibited by § 10(b) and Rule 10b-5.[63] In general, spoofing refers to placing and quickly cancelling orders that are never intended to be executed. Such orders can induce trading by other market participants (*e.g.*, high-speed algorithmic traders) who seek to take advantage of changes to supply and demand in the order

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[57] *Masri*, 523 F. Supp. 2d at 365.

[58] *Masri*, 523 F. Supp. 2d at 366 (quoting *Markowski*, 274 F.3d 525, 527-28 (D.C. Cir. 2001)).

[59] *Markowski*, 274 F.3d at 529; *cf. Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 383 (S.D.N.Y. 1973) ("The securities laws do not proscribe all buying or selling which tends to raise or lower the price of a security. . . . So long as the investor's motive in buying or selling a security is not to create an artificial demand for, or supply of, the security, illegal market manipulation is not established."). *See also United States v. Radley*, 632 F.3d 177 (5th Cir. 2011) (holding that traders could mislead other market participants about their trading intentions with respect to open market orders).

[60] *Masri*, 523 F. Supp. 2d at 366 (citing *Nanopierce Techs., Inc. v. Southridge Capital Mgmt. LLC*, 02-civ-00767 (S.D.N.Y. Oct. 10, 2002)).

[61] 938 F.2d 364, 366-68 (2d Cir. 1991); *see also Onel v. Top Ships, Inc.*, 19-cv-02693, at *3-5 (2d Cir. Apr. 2, 2020) ("In sum, then, a claim of market manipulation [under § 10(b)] requires a showing that the defendants took some action that was intended to mislead the investing public concerning the price of the relevant security, which in turn requires an allegation that the defendants' conduct included a misrepresentation or nondisclosure.")

[62] *See, e.g.*, *Masri*, 523 F. Supp. 2d at 366 ("[I]f an investor conducts an open-market transaction with the intent of artificially affecting the price of the security, and not for any legitimate economic reason, it can constitute market manipulation. . . . Allegations of other deceptive conduct or features of the transaction are only required to the extent that they render plausible allegations of manipulative intent."); *In re Initial Public Offering Securities Litigation*, 241 F. Supp. 2d 281, 391 (S.D.N.Y. 2003) (finding no authority supporting any additional requirements beyond bad intent in open market cases); *SEC v. Kwak*, 04-cv-1331, at *2-*4 (D. Conn. Feb. 12, 2008) (rejecting the idea that open market purchases created a safe harbor for defendants or that section 10(b) or 9(a) claims) could only be brought in traditional manipulation cases); *United States v. Finnerty*, 05-cr-00397, at *1 (S.D.N.Y. Oct. 2, 2006) (rejecting the argument that the term "deceptive" is limited to sham transactions and ruling that a "deceptive" act is anything which "tends to deceive" or "has the power to mislead") (citing *United States v. Bongiorno*, 05-cr-00390, 2006 WL 1140864 (S.D.N.Y. May 1, 2006)).

[63] *See* John Sanders & Andrew Verstein, *Legal Confusion as to Spoofing*, HUFFINGTON POST (May 12, 2015) (noting that by maintaining separate manipulation laws for securities and commodities futures, US law "prohibits spoofing a half a dozen times, each time with different elements, and only one time by name.").

book. "Layering" is a type of spoofing that involves a series of spoof orders placed at different price levels increasingly far from the prevailing best price.

In *SEC v. Lek Sec. Corp.*, for example, the defendants were charged with § 10(b) violations for engaging in a layering scheme involving the placing of allegedly "non-bona fide orders"—*i.e.* ones they did not "intend to execute and had no legitimate economic reason—with the "intent of injecting false information into the market about supply or demand" for certain stocks.[64] The alleged purpose of this scheme was to "trick and induce other market participants to execute against orders that [defendants] did intend to execute for the same stock on the opposite side of the market, which the complaint describes as its bona fide orders. Through this scheme, [defendants allegedly sought] more favorable prices on the executions of its bona fide orders than otherwise would have been available."[65]

Lek Securities and the other defendants moved to dismiss the SEC's complaint in its entirety on various grounds. In an opinion addressing the applicability of § 10(b) to spoofing/layering, the Southern District of New York accepted the SEC's theory and denied defendants' motion:

> [Market manipulation] broadly includes those practices "that are intended to mislead investors by artificially affecting market activity." In considering whether an act injects false pricing signals into the market, courts recognize that one of the fundamental goals of the federal securities laws is . . . "to prevent practices that impair the function of stock markets in enabling people to buy and sell securities at prices that reflect undistorted (though not necessarily accurate) estimates of the underlying economic value of the securities traded. . . . Market manipulation can be accomplished through otherwise legal means. As the Second Circuit has noted, "in some cases scienter is the only factor that distinguishes legitimate trading from improper manipulation."[66]

Several other courts have also concluded that spoofing can violate § 10(b) and Rule 10b-5.[67] Sam Lek and his company settled the SEC's claims before in exchange for a $1.42 million penalty, disgorgement of $525,892, and a compliance monitor for three years. The remaining defendants were found guilty after trial in November 2019. In March 2020, a final judgment was issued that imposed a nearly $20 million combined penalty (that is currently being appealed).[68]

C. <u>1933 Securities Act</u>

Congress's overarching purpose in passing the '33 Act was to "provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical

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[64] 276 F. Supp. 3d 49, 54 (S.D.N.Y. 2017).
[65] *Id.*
[66] *Id.* at 59-60 (citing *ATSI*, 493 F.3d at 102).
[67] *See, e.g.*, *CP Stone Fort Holdings, LLC v. Does*, 2017 WL 1093166, at *4 (N.D. Ill. Mar. 22, 2017); *United States v. Milrud*, 15-cr-00455 (D.N.J. Sept. 10, 2015); *see also In the Matter of Terrance Yoshikawa*, 87 S.E.C. Docket 2580, 2006 WL 1113518, at *7 n.36 (Apr. 26, 2006) (describing the SEC's history since 1998 of finding spoofing/layering to violate § 10(b) and Rule 10b-5).
[68] *SEC v. Lek Sec. Corp., et al.*, 17-cv-01789 (S.D.N.Y. 2017).

standards of honesty and fair dealing."[69] The statute's key anti-fraud provision is Section 17(a) (15 U.S.C. § 77q), which provides:

> It shall be unlawful for any person in the offer or sale of any securities or any security-based swap agreement by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud, or
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

While the structure of § 17(a) is similar to Exchange Act § 10(b) and Rule 10b-5, § 17(a) is broader because civil claims brought by the SEC under § 17(a)(2) and (a)(3) may be based on negligent conduct, while such claims under § 10(b) require proof of scienter.[70] But the possible penalties for § 17(a) violations are lower—any person found guilty of a "wilful" violation is subject to a maximum fine $10,000 and/or five years in prison.[71]

In several recent cases, the SEC has taken the position that spoofing violates § 17(a). In its 2020 DPA with JP Morgan, for example, the SEC alleged a violation of § 17(a)(3) in light of a long-running scheme to spoof the U.S. Treasuries market.[72] Likewise, in *SEC v. Chen*, the SEC charged dozens of mainly China-based traders with violations of §§ 17(a)(1) and (a)(3) for engaging in a coordinated scheme to artificially influence the prices of various publicly traded securities in the US through nominee trading accounts.[73] Other cases where the SEC alleged § 17(a) violations for spoofing or spoofing-like conduct include *Behruz Afshar, et al.*, Securities Act Release No. 9983 (SEC Dec. 3, 20150), *Briargate Trading LLC, et al.*, Securities Act Release No. 9959 (SEC Oct. 8, 2015), *SEC v. Milrud*, 15-cv-00237 (D.N.J.), and *SEC v. Pomper*, 01-cv-07391 (E.D.N.Y.).

D. <u>1936 Commodity Exchange Act</u>

In addition to combatting manipulation and fraud on stock exchanges, during the Great Depression the U.S. government was concerned with perceived wrongdoing in the commodities markets.[74] To address this issue, Congress passed the Commodity Exchange Act (CEA) in 1936. As the

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[69] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185,195 (1976).

[70] Courts have determined that the standard for negligence under § 17(a) permits consideration of "any evidence of industry practice, custom, or standards, as they pertained to a reasonably prudent person in [the defendant's] position at the time." Jury Instructions, *SEC v. Stoker*, 11-cv-07388 (S.D.N.Y.), Dkt. # 89; *see also SEC v. Shanahan*, 646 F.3d 536, 546 (8th Cir. 2012) (holding that negligence standard for § 17(a)(2) and (a)(3) claims required consideration of the defendant's "duties as a member of [the company's] Board of Directors and as a member of the Compensation Committee.").

[71] 15 U.S.C. § 77x.

[72] In re. JP Morgan Securities LLC, SEC Dkt. #3-20094 (Sept. 29, 2020).

[73] *SEC v. Chen, et al.*, 19-cv-012127 (D. Mass.).

[74] *See generally* Jerry W. Markham, *Law Enforcement and the History of Financial Market Manipulation* (New York: Routledge 2015), p. 76-87. A commodity futures contract is an agreement to buy or sell a particular commodity at a future date. The price and the amount of the commodity are fixed at the time of the agreement, and in general the contract specifies that it may be fulfilled by

Second Circuit described the law, "[T]he CEA is a remedial statute that serves the crucial purpose of protecting the innocent individual investor—who may know little about the intricacies and complexities of the commodities market—from being misled or deceived." *Loginovskaya v. Batratchenko*, 764 F.3d 266, 270 (2d Cir. 2014). Like stock exchanges, futures exchanges were deemed to be of national importance and in need of more stringent regulation: "The transactions and prices of commodities on such boards of trade are susceptible to excessive speculation and can be manipulated, controlled, cornered or squeezed . . . rendering regulation of such transactions imperative for the protection of such commerce and the national public interest."[75]

In 1974, the CEA was substantially amended by the Commodity Futures Trading Commission Act which, among other things, created the CFTC to assume responsibility for the CEA's regulation and enforcement.[76] The CFTC's anti-manipulation authority extends to spot and forward physical commodity transactions, as well as exchange-traded and over-the-counter derivatives (futures contracts and options). A knowing violation of the CEA's anti-manipulation provisions, contained in CEA §§ 4(c) and 9(a), is a felony punishable by up to 10 years in prison and a fine of not more than $1,000,000.[77]

In the first few decades of the CFTC's existence, a generally accepted four-part test for manipulation under the CEA developed: (1) intent to manipulate prices; (2) the ability to influence prices; (3) existence of an artificial price; and (4) causation of the artificial price.[78] This standard proved exceedingly difficult for the CFTC to satisfy when challenged.[79] In fact, since 1974 the CFTC has only won a single market manipulation case decided in a contested proceeding.[80] It was reportedly for this reason that legislation was introduced in 2010 to ease the CFTC's burden in enforcement actions (see below).[81]

1. <u>CEA Section 4(c)(1)-(4) (7 U.S.C. § 6c(a)(1)-(4)) – Prohibited Transactions</u>

CEA §§ 4(c)(a)(2) prohibits commodities futures transactions that are "of the character of" "wash" sales, "cross" trades, "accommodation" trades or "fictitious" sales. It also prohibits any transaction that "is used to cause any price to be reported, registered, or recorded that is not a true and bona fide price." The CEA's prohibitions against "wash sales" and matched orders have been interpreted essentially the

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either physical delivery of the commodity or cash settlement. *See* CFTC, "Basics of Futures Trading," https://www.cftc.gov/LearnAndProtect/ AdvisoriesAndArticles/FuturesMarketBasics/index.htm.

[75] Markham, *supra*, at 90.

[76] *Merrill Lynch, Pierce, Fenner Smith v. Curran*, 456 U.S. 353, 388 (1982).

[77] 7 U.S.C. § 13(a).

[78] *Frey v. CFTC*, 931 F.2d 1171, 1175 (7th Cir. 1991).

[79] *See* Markham, *supra*, p. 184-191.

[80] 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 (2d Cir. 2009). In this case, the CFTC accused a NYMEX broker of helping an energy trading firm manipulate prices of electricity futures contracts. To show that the broker had the ability to influence prices, the CFTC pointed to evidence showing that the contracts at issue were illiquid and the broker's trading volume constituted a significant percentage of the total on the trading days in question. The CFTC established that artificial prices were created by the broker violating bids and offers of other traders by offering at lower than prevailing bids or bidding at higher than prevailing offers.

[81] Matthew Leising, *Market Cops Got Power to Pursue Spoofers After Years of Failure*, BLOOMBERG (May 14, 2015), https://www.bloomberg.com/news/articles/2015-05-14/market-cops-got-power-to-pursue-spoofers-after-years-of-failure.

same way as the Exchange Act's.[82] The elements of such a claim are: (1) a purchase and sale of any commodity for future delivery; (2) of the same delivery month of the same futures contract; (3) at the same or similar price; and (4) with the intent of not making a bona fide transaction.[83]

Both the CFTC and courts interpreted these provisions to require proof of a specific intent to manipulate.[84] As the Second Circuit noted, "One cannot have an 'accommodation' sale or a 'fictitious' transaction if one in fact believes he is bargaining faithfully and intends to effect a bona fide trade."[85]

2. <u>The CEA's Anti-Spoofing Provision</u>

Following the 2008/2009 financial crisis, Congress expanded Section 4(c) through a provision in 2010's Dodd-Frank Wall Street Reform and Consumer Protection Act.[86] Specifically, § 747 of Dodd-Frank added prohibitions on "disruptive practices" to CEA § 4(c). The new section (7 U.S.C. § 6c(a)(5)) states that it "shall be unlawful for any person to engage in any trading, practice, or conduct on or subject to the rules of a registered entity that—(A) violates bids or offers; (B) demonstrates intentional or reckless disregard for the orderly execution of transactions during the closing period; (C) 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)."

Of these additions, the anti-spoofing provision ("ASP") has generated the most controversy. From the beginning, it was attacked as vague and overbroad. Commentators noted in particular that the ASP has no drafting or legislative history—it "simply materialized with no public discussion, [and so] there is literally nothing in the legislative record to illuminate the provision's meaning or reach."[87] Market professional were also dismayed at the inclusion of the word "spoofing" in the statute since "spoofing" had no accepted meaning in the futures and derivatives markets.

During a December 2010 roundtable discussion hosted by the CFTC, for example, Kenneth Raisler, former General Counsel of the CFTC, noted "It is hard to imagine how [spoofing] even applies to the futures world or how it should be applied."[88] The CEO of the CME Group—one of the world's major exchange operators—similarly stated that "[t]he statute's definition of 'spoofing' . . . is too broad and does not differentiate legitimate market conduct from manipulative conduct that should be prohibited."[89]

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[82] *See, e.g.*, *Gracey v. J.P. Morgan Chase & Co.*, 730 F.3d 170, 187 (2d Cir. 2013); *In re Piasia*, 2000 WL 1466069, at *3 (CFTC Sept. 29, 2000) *aff'd sub nom. Piasia v. CFTC*, 54 Fed. Appx. 702 (2d Cir. 2002); *In re LFG, LLC,* 2001 WL 940235, at *1 (CFTC Aug. 20, 2001); *CFTC v. Moncanda*, 31 F. Supp. 3d 614, 616-618 (S.D.N.Y. 2014).
[83] *Wilson v. CFTC*, 322 F.3d 555, 559-60 (8th Cir. 2003).
[84] *See, e.g.*, *In re Amaranth Natural Gas Commodities Litig.*, 730 F.3d 170, 173 (2d Cir. 2013).
[85] *Reddy v. CFTC*, 191 F.3d 109, 119 (2d Cir. 1999).
[86] Public Law 111-203, 124 Stat. 1376 (2010).
[87] Motion to Dismiss, *United States v. Coscia*, 14-cr-00551, Dkt. #28 (Dec. 15, 2014 N.D. Ill.), at 5.
[88] *Id.* at 8.
[89] *Id.* at 9.

Following these criticisms, the CFTC issued interpretative guidance in May 2013 "to provide market participants and the public with guidance on the manner in which it intends to apply the statutory prohibitions set forth in section 4c(a)(5)." In pertinent part, the guidance states:

- CEA § 4(c)(a)(5)(A) prohibits "a person from buying a contract on a registered entity at a price that is higher than the lowest available price offered for such contract or selling a contract on a registered entity at a price that is lower than the highest available price bid for such contract." This is "a per se offense," meaning that it is illegal regardless of the circumstances in which it occurs.

- A CEA § 4(c)(a)(5)(B) violation "may occur when a market participant accumulates a large position [or submits bids and offers] . . . in the period immediately preceding the closing period with the intent (or reckless disregard) to disrupt the orderly execution of transactions during . . . the closing period."

- "Spoofing" under CEA § 4(c)(a)(5)(C) "includes, but is not limited to: (i) submitting or cancelling bids or offers to overload the quotation system of a registered entity; (ii) submitting or cancelling bids or offers to delay another person's execution of trades; (iii) submitting or cancelling multiple bids or offers to create an appearance of false market depth; and (iv) submitting or cancelling bids or offers with intent to create artificial price movements upwards or downwards."[90]

As to spoofing, the CFTC's guidance went on to state that "a spoofing violation will not occur when the person's intent when cancelling a bid or offer before execution was . . . part of a legitimate, good-faith attempt to consummate a trade." It further stated that the CFTC "does not interpret reckless trading, practices, or conduct as constituting a 'spoofing' violation," nor does it interpret the ASP as "reaching accidental or negligent trading, practices, or conduct." "When distinguishing between legitimate trading (such as trading involving partial executions) and 'spoofing,'" the CFTC explained that it would "evaluate the market context, the person's pattern of trading activity (including fill characteristics), and other relevant facts and circumstances."[91] Even with this guidance, the ASP continues to be attacked as inherently vague. So far, courts have been largely unreceptive to these arguments.[92]

a. <u>What is Spoofing?</u>

As noted above, spoofing generally refers to the placing of "trick" orders—*i.e.*, orders intended to be cancelled—on one side of the market in order to deceptively induce other market participants into filling "real" orders lying in wait on the other side. In a typical spoofing scheme, a trader will place one or more relatively small, genuine orders on the opposite side of the market from larger, non-bona fide orders in order to take advantage of how other traders react to large changes in supply and demand.

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[90] CFTC, *Antidisruptive Practices Authority,* 78 Fed. Reg. 31890-31896 (May 28, 2013).
[91] *Id.*
[92] *See, e.g.*, Joshua Ray, "CFTC Continues to Target Small Overseas 'Spoofers'," TRADERS MAGAZINE (October 12, 2020), https://www.tradersmagazine.com/am/cftc-continues-to-target-small-overseas-spoofers/.

In its 2015 criminal spoofing trial against Michael Coscia, for example, DOJ introduced an exhibit[93] showing the following sequence in Coscia's trade data:

"Trick" Orders

"Real" Orders

Time	Transaction Type	Buy	Sell	Quantity	Price
8:33:19.614	Entered	Buy		18	15427
8:33:19.629	Entered		Sell	176	15430
8:33:19.737	Entered		Sell	145	15429
8:33:19.855	Entered		Sell	74	15428
8:33:19.923	Filled	Buy		10	15427
8:33:19.923	Filled	Buy		8	15427
8:33:19.936	Cancelled		Sell	74	15428
8:33:19.942	Cancelled		Sell	145	15429
8:33:19.945	Cancelled		Sell	176	15430
8:33:19.952	Entered		Sell	18	15428
8:33:19.991	Entered	Buy		176	15424
8:33:20.093	Entered	Buy		183	15425
8:33:20.202	Entered	Buy		171	15426
8:33:20.312	Entered	Buy		165	15427
8:33:20.316	Filled		Sell	1	15428
8:33:20.316	Filled		Sell	3	15428
8:33:20.317	Filled		Sell	1	15428
8:33:20.320	Filled		Sell	5	15428
8:33:20.320	Filled		Sell	5	15428
8:33:20.321	Filled		Sell	3	15428
8:33:20.345	Cancelled	Buy		165	15427
8:33:20.354	Cancelled	Buy		171	15426
8:33:20.355	Cancelled	Buy		183	15425
8:33:20.359	Cancelled	Buy		176	15424

DOJ used this data as circumstantial evidence that the Buy orders were "trick" orders that Coscia's trading algorithm entered in order to push the market towards his "real" Sell orders. To show that the Buy orders were not intended to trade, DOJ pointed to the fact that they were immediately cancelled after the Sell orders were filled (after being left open for just a fraction of a second).

Coscia was eventually convicted and sentenced to three years in prison. In upholding his conviction and sentence on appeal, the Seventh Circuit described the conduct prohibited by the ASP:

> "In practice, spoofing, like legitimate high-frequency trading, utilizes extremely fast trading strategies. It differs from legitimate trading, however, in that it can be employed to *artificially move* the market price of a stock or commodity up and down, instead of taking advantage of natural market events . . . . This artificial movement is accomplished in a number of ways, although it is most simply realized by placing large and small orders on opposite sides of the market. The small order is placed at a desired price, which is either above or below the current market price, depending on whether the trader wants to buy or sell. If the trader wants to buy, the price on the small batch will be lower than the market price; if the trader wants to sell, the price on the small batch will be higher. Large orders are then placed on the opposite side of the market at prices designed to shift the market toward the price at which the small order was listed."[94]

While the trading sequence described by the Seventh Circuit has come to typify the conduct that law enforcement generally focuses on in spoofing actions, it made clear that all the ASP requires the government to prove in such cases is an intent to cancel an order at the time it is placed.[95]

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[93] *United States v. Coscia*, 14-cr-00551, Dkt. #177-21 (N.D. Ill.).
[94] *United States v. Coscia*, 866 F.3d 782, 787 (7th Cir. 2017).
[95] *Id.* at 795 ("[A] conviction for spoofing requires that the prosecution prove beyond a reasonable doubt that Mr. Coscia knowingly entered bids or offers with the present intent to cancel the bid or offer prior to execution.").

b. Evolving Theories of Liability for Spoofing

The *Coscia* case was the first criminal prosecution alleging violations of the ASP. But perhaps to hedge against constitutional vagueness challenges to the then-untested law, the DOJ also charged him with commodities fraud under 18 U.S.C. § 1348(1). Section 1348(1) makes it a crime to "defraud any person in connection with any commodity for future delivery." The elements of this crime are (1) fraudulent intent, (2) a scheme or artifice to defraud, and (3) a nexus with a security. "False representations or material omissions are not required" for conviction under this provision.[96]

In his appeal, Coscia argued that because all of "his orders were fully executable and subject to legitimate market risk," they could not, as a matter of law, be fraudulent or otherwise violate Section 1348(1). But the Seventh Circuit disagreed, finding that his argument "confused illusory orders with an illusion of market movement." The court noted that the evidence supported the conclusion that Coscia "designed a scheme to pump and deflate the market through the placement of large orders. His scheme was deceitful because, at the time he placed the large orders, he intended to cancel the large orders . . . and thus sought to manipulate the market for his own financial gain."[97]

Following Coscia's conviction and the Seventh Circuit's favorable interpretation of the ASP and Section 1348(1), the DOJ and CFTC have brought dozens of additional spoofing cases in the last five years (most often in the Northern District of Illinois, a court bound by decisions of the Seventh Circuit Court of Appeals). While the fundamental conduct at issue in these cases is largely the same as that in *Coscia*, prosecutors' theories of liability have evolved beyond the ASP and Section 1348(1).

In *United States v. Vorley*, for example, DOJ did not allege violations of the ASP at all (even though the alleged wrongdoing was clearly spoofing). Instead, prosecutors opted to charge the defendants, both former precious metals traders, with wire fraud in violation of 18 U.S.C. § 1343. In a motion to dismiss the indictment, the defendants argued that the wire fraud statute requires allegations of an affirmative "false statement" and that the case against them failed to do so, since all that was alleged was that they put certain orders into the order book.

The district court judge disagreed, however: "The wire fraud statute proscribes not only false statements and affirmative representations but also 'the omission or concealment of material information, even absent an affirmative duty to disclose, if the omission was intended to induce a false belief and action to the advantage of the scheme and the disadvantage of the victim.' And that is precisely what the indictment alleges here: that the defendants did not disclose, at the time they placed their Spoofing Orders, their intent to cancel the orders before they could be executed, inducing by the placement of those orders a false belief about the supply or demand for a commodity, so that the

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[96] *United States v. Mahaffy*, 693 F.3d 113, 125 (2d Cir. 2012).
[97] *Coscia*, 866 F.3d at 797.

market would move in a direction that favored the Primary Orders, to their benefit and to the detriment of traders in the market who were not privy to the fact that the defendants intended to cancel the Spoofing Orders before they were accepted."[98]

In *United States v. Smith*, DOJ used an even more aggressive charging theory. There, prosecutors alleged that four former JP Morgan employees violated the ASP in addition to four alternate substantive offenses: attempted price manipulation, bank fraud (18 U.S.C. § 1344(1), wire fraud affecting a financial institution (18 U.S.C. § 1343), and commodities fraud (18 U.S.C. § 1348(1)). In addition, prosecutors alleged that the defendants had participated in a racketeering conspiracy in violation of the RICO statute (18 U.S.C. §§ 1961-1968).[99] Defendants' motion to dismiss this indictment is currently pending before the court.

To date, DOJ has brought criminal spoofing actions against twenty-one individuals alleging violations of various different statutes:

Defendant	Alleged Statute Violated	Disposition
Michael Coscia 14-cr-00551 (N.D. Ill.)	Spoofing (7 U.S.C. § 6c(a)(5)(C)) Commodities Fraud (18 U.S.C. § 1348)	Guilty after trial Sentence: 36 months
Navinder Sarao 15-cr-00075 (N.D. Ill.)	Spoofing (7 U.S.C. § 6c(a)(5)(C)) Wire Fraud (18 U.S.C. § 1343) Commodities Fraud (18 U.S.C. § 1348)	Guilty plea with cooperation Sentence: 12 months home confinement
David Liew 17-cr-00001 (N.D. Ill.)	Conspiracy (18 U.S.C. § 371)	Guilty plea with cooperation Sentence: pending
Andre Flotron 17-cr-00220 (D. Conn.)	Conspiracy (18 U.S.C. § 1349) Commodities Fraud (18 U.S.C. § 1348) Spoofing (7 U.S.C. § 6c(a)(5)(C)) Manipulation (7 U.S.C. § 13(a)(2)) Aiding and Abetting (18 U.S.C. § 2)[100]	Not guilty after trial
Jiongsheng Zhao 18-cr-00024 (N.D. Ill.)	Spoofing (7 U.S.C. § 6c(a)(5)(C)) Manipulation (7 U.S.C. § 13(a)(2))	Guilty plea with cooperation Sentence: time served
John Edmonds 18-cr-00239 (D. Conn.)	Conspiracy (18 U.S.C. § 371) Commodities Fraud (18 U.S.C. § 1348)	Guilty plea with cooperation Sentence: pending
Kamaldeep Gandhi 18-cr-00609 (S.D. Tex.)	Conspiracy (18 U.S.C. § 371)	Guilty plea with cooperation Sentence: pending
Krishna Mohan 18-cr-00610 (S.D. Tex.)	Conspiracy (18 U.S.C. § 371)	Guilty plea with cooperation Sentence: pending
Edward Bases 18-cr-00048 (N.D. Ill.)	Wire Fraud (18 U.S.C. § 1343) Commodities Fraud (18 U.S.C. § 1348) Conspiracy (18 U.S.C. § 1349)	Trial scheduled for September 2021
John Pacilio 18-cr-00048 (N.D. Ill.)	Wire Fraud (18 U.S.C. § 1343) Commodities Fraud (18 U.S.C. § 1348) Conspiracy (18 U.S.C. § 1349) Spoofing (7 U.S.C. § 6c(a)(5)(C)) Manipulation (7 U.S.C. § 13(a)(2))	Trial scheduled for September 2021
Jitesh Thakkar 18-cr-00036 (N.D. Ill.)	Spoofing (7 U.S.C. § 6c(a)(5)(C)) Manipulation (7 U.S.C. § 13(a)(2)) Conspiracy (18 U.S.C. § 371) Aiding and Abetting (18 U.S.C. § 2)	Charges dismissed after mistrial
James Vorley 18-cr-00035 (N.D. Ill.)	Wire Fraud (18 U.S.C. § 1343) Conspiracy (18 U.S.C. § 1349)	Guilty after trial Sentence: pending
Cedric Chanu 18-cr-00035 (N.D. Ill.)	Wire Fraud (18 U.S.C. § 1343) Conspiracy (18 U.S.C. § 1349)	Guilty after trial Sentence: pending
Corey Flaum	Manipulation (7 U.S.C. § 13(a)(2))	Guilty plea with cooperation

[98] *United States v. Vorley*, 18-cr-00035 (N.D. Ill. Oct. 21, 2019), Dkt. #119 at 6-7.
[99] *United States v. Smith*, 19-cr-00669 (N.D. Ill.).
[100] All counts except for the conspiracy count against Flotron were dismissed on defendant's pre-trial motion.

19-cr-00338 (E.D.N.Y.)		Sentence: pending
Christian Trunz 19-cr-00375 (E.D.N.Y.)	Manipulation (7 U.S.C. § 13(a)(2))	Guilty plea with cooperation Sentence: pending
Xiasong Wang 19-mj-06485 (D. Mass.)	Conspiracy (18 U.S.C. § 371)	Pending (no trial date set)
Jiali Wang 19-mj-06485 (D. Mass.)	Conspiracy (18 U.S.C. § 371)	Pending (no trial date set)
Gregg Smith 19-cr-00669 (N.D. Ill.)	Spoofing (7 U.S.C. § 6c(a)(5)(C)) Manipulation (7 U.S.C. § 13(a)(2)) Conspiracy (18 U.S.C. § 371) Wire Fraud (18 U.S.C. § 1343) Commodities Fraud (18 U.S.C. § 1348) Racketeering Conspiracy (18 U.S.C. § 1962(d))	Trial scheduled for October 2021
Michael Nowak 19-cr-00669 (N.D. Ill.)	Spoofing (7 U.S.C. § 6c(a)(5)(C)) Manipulation (7 U.S.C. § 13(a)(2)) Conspiracy (18 U.S.C. § 371) Wire Fraud (18 U.S.C. § 1343) Commodities Fraud (18 U.S.C. § 1348) Racketeering Conspiracy (18 U.S.C. § 1962(d))	Trial scheduled for October 2021
Christopher Jordan 19-cr-00669 (N.D. Ill.)	Spoofing (7 U.S.C. § 6c(a)(5)(C)) Manipulation (7 U.S.C. § 13(a)(2)) Conspiracy (18 U.S.C. § 371) Wire Fraud (18 U.S.C. § 1343) Commodities Fraud (18 U.S.C. § 1348) Racketeering Conspiracy (18 U.S.C. § 1962(d))	Trial scheduled for October 2021
Jeffrey Ruffo 19-cr-00669 (N.D. Ill.)	Racketeering Conspiracy (18 U.S.C. § 1962(d))	Trial scheduled for October 2021

3. CEA Section 6(c)(1) (7 U.S.C. § 9(1))

Dodd-Frank also added a general anti-manipulation provision in Section 6(c)(1) to the CEA. The new section makes it "unlawful for any person, directly or indirectly, to use or employ, or attempt to use or employ, in connection with any swap, or a contract of sale of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity, any manipulative device or contrivance, in contravention of such rules and regulations as the [CFTC] shall promulgate by not later than 1 year after July 21, 2010 . . . ."

The language of this new section is "virtually identical"[101] to Exchange Act § 10 (b), and its legislative history shows that Congress designed it to give the CFTC anti-manipulation powers equivalent to the SEC.[102] Given the CFTC's difficulties in proving manipulation before this law, it was apparently designed to lower the legal hurdles the CFTC needed to overcome in such cases. In introducing the legislation, its sponsor, Senator Cantwell, specifically highlighted that "[i]n the 35 years of its history, the CFTC has only successfully prosecuted one single case of manipulation."[103]

To implement § 6(c)(1)'s provisions, the CFTC issued an analogue to Rule 10b-5, Rule 180.1, in 2011. Rule 180.1 makes it unlawful to "intentionally or recklessly . . . use or employ, or attempt to use or employ, any manipulative device, scheme, or artifice to defraud." Despite the close similarities with Rule 10b-5, the CFTC stated that "judicial precedent should guide, but not control, application of the

[101] *In re. Commodity Exchange Inc.*, 213 F. Supp. 3d 631, 672 (S.D.N.Y. 2016).
[102] *See* David Yeres, Robert Houch, and Brendan Stuart, *US Market Manipulation: Has Congress Given the CFTC Greater Latitude than the SEC to Prosecute Open Market Trading as Unlawful Manipulation? It's Doubtful*, FUTURES & DERIVATIVES LAW REPORT (June 2018).
[103] 156 Cong. Rec. S3333 (May 6, 2010).

scienter standard under subsection 6(c)(1) and the CFTC's implementing rule."[104] As such, the CFTC has taken the position that a mere showing of "recklessness" is sufficient to prove a § 6(c)(1) violation,[105] which it defines as "an act or omission that departs so far from the standards of ordinary care that it is very difficult to believe the actor was not aware of what he or she was doing."[106]

On November 6, 2013, the CFTC flexed it's new anti-manipulation authority in a complaint failed against Donald R. Wilson and his company, DRW Investments LLC.[107] The CFTC alleged Wilson violated CEA §§ 6(c) and 9(a)(2) by placing inflated bids "for certain futures contracts with the intent to move the prices of the contracts in their favor" and "to increase the value of the futures contract positions they held in their portfolio."[108] Following a denial of defendants' motion to dismiss, the case proceeded to a four-day bench trial before Judge Sullivan in December 2016.

In 2018, Judge Sullivan issued a decision concluding that the CFTC had failed to prove its case under the four part *Frey* standard. While Judge Sullivan found that the CFTC established the first element—ability to influence price—he concluded that "its case founders on its abject failure to produce evidence—or even a coherent theory—supporting the existence of an artificial price." Citing an earlier CFTC case, Judge Sullivan noted that "a price is artificial when it has been set by some mechanism which has the effect of 'distort[ing] those prices' and 'preventing the determination of those prices by free competition alone.'" On that point, the CFTC "offered no evidence or explanation demonstrating" artificial prices, but rather introduced testimony from a single expert who opined that prices were artificial because they were influenced by "DRW's self-serving actions."

Judge Sullivan flatly rejected this theory. "The inescapable conclusion from the evidence introduced at trial is that DRW's bids, and the consequent settlement prices, were the result of free competition, since sophisticated market participants would surely have accepted Defendant's open bids if they thought they were above market value. . . . That, after all, is how markets work, and the CFTC's failure to articulate any theory as to why the market was inefficient, or why would-be counterparties were prevented from enforcing market discipline by hitting DRW's allegedly inflated bids, is ultimately fatal to its claim."

Judge Sullivan went on to criticize the CFTC's conflation of "artificial prices with the mere intent to affect prices." "Relying on dictum in its own thirty-five year-old administrative decision, the CFTC essentially argues that *any* price influenced by Defendants' bids was 'illegitimate,' and by definition 'artificial,' because Defendants understood and intended that the bids would have an effect on the settlement prices. . . . This theory, which take to its logical conclusions would effectively bar market

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[104] 75 Fed. Re. 67657, 67658.
[105] *See, e.g.*, Gov'ts Opp. To Mot. To Dismiss at 18-20, 21-22, *CFTC v. Kraft Foods Grp., Inc.*, 15-cv-02881, Dkt. 64 (N.D. Ill.).
[106] 76 Fed. Reg. at 41404.
[107] *CFTC v. Wilson*, 13-cv-07884, 2018 WL 6322024 (S.D.N.Y. Nov. 30, 2018).
[108] *Id.*

participants with open positions from ever making additional bids to pursue future transactions, finds no basis in law."

The CFTC's attempted market manipulation allegations were similarly dispensed with. "Unlike market manipulation, attempted market manipulation does not require proof of an artificial price—only that Defendants 'acted (or failed to act) with the purpose or conscious object of causing or effecting a price or price trend in the market that did not reflect the legitimate forces of supply and demand.' But again the mere intent to affect *prices* is not enough; rather, the CFTC must show that Defendants intended to cause *artificial* prices—*i.e.*, prices that they understood to be unreflective of the forces of supply and demand."

Soon after its loss in *Wilson*, the CFTC quietly settled *CFTC v. Kraft Foods Grp., Inc.*, 15-cv-02881 (N.D. Ill.), one of the handful of litigated enforcement actions brought under Section 6(c)(1). There, the CFTC took the position that § 6(c)(1) and Rule 180.1 do not require proof of specific intent or the existence of an artificial price (in contradiction to Judge Sullivan's findings). In other words, the CFTC argued that it could allege a scheme to defraud involving otherwise legal, open market transactions. In a ruling on defendant's motion to dismiss, the court rejected the CFTC's claim and determined that § 6(c)(1) and Rule 180.1 "prohibit only fraudulent conduct."[109] But in light of the result in *Wilson*, the CFTC resolved the case before be addressed on the merits. And in an unusual move, this settlement was reached without any public findings of fact or conclusions of law.[110] In fact, the CFTC included in the settlement agreement a provision preventing it from making any public statements about the case in the future. Because the CFTC's negotiated silence on the *Kraft* settlement leaves "the industry without any intelligible guidance" on what manipulative conduct Section 6(c)(1) and Rule 180.1 prohibit, the CFTC is currently the subject of a Freedom of Information Act lawsuit that seeks to reveal the legal and factual bases for the settlement.[111]

4. <u>Section 9(a) (7 U.S.C. § 13(a)) – Violations generally</u>

Section 9(a)(2) makes it unlawful for "any person to manipulate or attempt to manipulate the price of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity, or of any swap, or to corner or attempt to corner any such commodity . . . ." Section 9(a)(4) makes it unlawful for "any person willfully to falsify, conceal, or cover up by any trick, scheme, or artifice a material fact, make any false, fictitious, or fraudulent statements or representations, or make

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[109] *CFTC v. Kraft*, 153 F. Supp. 3d 996, 1008 (N.D. Ill. 2015). The court's conclusion in *Kraft* is in tension with a decision by the Ninth Circuit in *CFTC v. Monex*, 931 F.3d 966 (9th Cir. 2019), which found § 6(c)(1) authorized the CFTC to "sue for fraudulently deceptive activity, regardless of whether it was also manipulative." The *Monex* decision has not been followed by at least two other courts outside the Ninth Circuit. *See, e.g.*, *CFTC v. My Big Coin Pay, Inc.*, 2018 WL 4621727 (D. Mass. Sept. 26, 2018); *CFTC v. Southern Trust Metals, Inc.*, 894 F.3d 1313 (11th Cir. 2018).
[110] *See* Complaint, *Kobre & Kim LLP v. CFTC*, 19-cv-10151 (N.D. Ill.).
[111] *Id.*

or use any false writing or document knowing the same to contain any false, fictitious, or fraudulent statement or entry to a registered entity, board of trade, swap data repository, or futures association."

Like Exchange Act § 10(b), these provisions in the CEA were designed to be a broad catchall for deceptive or manipulative behavior.[112] Courts have generally held that manipulation under the CEA does not necessarily involve an "explicit misrepresentation."[113]

a. Manipulation Under CEA § 9(a)(2) (7 U.S.C. § 13(a)(2))

Section 9(a)(2) of the CEA makes it unlawful for "[a]ny person to manipulate or attempt to manipulate the price of any commodity in interstate commerce." The CEA does not define the term "manipulate," but federal courts and the CFTC have held that manipulation is "an intentional exaction of a price determined by forces other than supply and demand."[114] "The elements of a market manipulation claim under section 9(a) are: (1) the defendant possessed an ability to influence market prices; (2) an artificial price existed; (3) the defendant caused the artificial price; and (4) the defendant specifically intended to cause the artificial price."[115]

i. *Proving an Ability to Influence Prices*

Where a defendant is alleged to have engaged in manipulation through a dominant market position, regulators must prove defendant held a controlling long position.[116] Market dominance depends on the deliverable supply of a commodity. [117] The deliverable supply of a commodity is supply that is readily available for delivery at a specified time, either because it is stored locally or because it is located within a deliverable distance from the market.[118]

Because the ability to influence prices "can manifest itself in various ways," whether a defendant exercised market power is a fact-intense inquiry.[119]

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[112] *See Cargill v. Hardin*, 452 F.2d 1154, 1163 (8th Cir. 1971) ("[The definition of manipulation] must largely be a practical one if the purposes of the Commodity Exchange Act are to be accomplished. The methods and techniques of manipulation are limited only by the ingenuity of man. The aim must be therefore to discover whether conduct has been intentionally engaged in which has resulted in a price which does not reflect basic forces of supply and demand.").

[113] *See CFTC v. Kraft Foods Grp., Inc.*, 153 F. Supp. 3d 996, 1011 (N.D. Ill. 2015) (holding that a manipulation claim may be based on misrepresentations or market manipulation); *In re Amaranth Natural Gas Comm. Litig.*, 587 F. Supp. 2d 513, 534 (S.D.N.Y. 2008) (finding that manipulation claim need not involve a "misstatement or omission" "[b]ecause every transaction signals that the buyer and seller have legitimate economic motivates for the transaction, [and] if either party lacks that motivation, the signal is inaccurate").

[114] *Frey v. CFTC*, 931 F.2d 1171, 1175 (7th Cir. 1991); *Volkart Bros. Inc. v. Freeman*, 311 F.2d 52, 58 (5th Cir. 1962) ("Manipulation is any and every operation or transaction or practice . . . calculated to produce a price distortion of any kind in any market either in itself or in relation to other markets. . . . Any and every operation, transaction (or) device, employed to produce these abnormalities of price relations in futures markets, is manipulation.").

[115] *In re Amaranth Natural Gas Commodities Litigation*, 587 F. Supp. 2d 513, 530-31 (S.D.N.Y. 2008); *DiPlacido v. CFTC*, 364 Fed.Appx. 657, 661 (2d Cir. 2009); *but see In re Soybean Futures Litig.*, 892 F. Supp. At 1045 (noting that the traditional four elements of proof in a manipulation case are "occasionally modified to fit the specific facts of a particular case, and there is some question to what extent these elements should be treated as separate and independent or whether they are factually and legally interdependent").

[116] *See Frey v. CFTC*, 931 F.2d 1171, 1175 (7th Cir. 1991); *CFTC v. Parnon Energy Inc.*, 875 F. Supp. 2d 233, 244 (S.D.N.Y. 2012).

[117] *Apex Oil Co. v. DiMauro*, 713 F. Supp. 587, 602 (S.D.N.Y. 1989).

[118] *See Cargill Inc. v. Hardin*, 452 F.2d 1154, 1165 (8th Cir. 1971).

[119] *Parnon Energy*, 875 F. Supp. 2d at 244.

ii. *What is an "Artificial Price"?*

An artificial price is a "price which does not reflect basic forces of supply and demand."[120] To determine whether a price is artificial, "One must look to the aggregate forces of supply and demand and search for those factors which . . . are not a legitimate part of the economic pricing of the commodity . . . . [W]hen a price is effected by a factor which is not legitimate, the resulting price is necessarily artificial. Thus, the focus should not be as much on the ultimate price, as on the nature of the factors causing it."[121]

"Determining artificiality involves an analysis of the suspected price in context of the aggregate supply and demand factors."[122] Proving the existence of an artificial price is, by design, inherently difficult so as to protect legitimate trading from unsupported accusations. "The laws that forbid market manipulation should not encroach on legitimate trading decisions lest they discourage the very activity that underlies the integrity of the markets they seek to protect. [As long as] a trading pattern is supported by a legitimate economic rationale, it cannot be the basis for liability under the CEA."[123]

iii. *Proving Intent to Cause an Artificial Price*

To meet the specific intent element of a claim for manipulation of a futures contract, a regulator must show that defendant "acted (or failed to act) with the purpose or conscious object of causing or effecting a price or price trend in the market that did not reflect the legitimate forces of supply and demand."[124] Because "proof of intent will most often be circumstantial in nature, manipulative intent must normally be shown inferentially form the conduct of the accused."[125] A generalized intent to obtain trading profits "which could be imputed to any corporation with a large market presence in any commodity market, is insufficient to show intent."[126]

iv. *Proving Causation*

The final element of a CEA market manipulation claim requires proof that the defendant cause the artificial price. "[C]ourts have recognized that there is some overlap between this element and the

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[120] *Cargill, Inc. v. Hardin*, 452 F.2d 1154, 1163 (8th Cir. 1971).
[121] *SEC v. Ficeto*, 839 F. Supp. 2d 1101, 1103 (C.D. Cal. 2011) (citing *In re Ind. Farm Bureau Coop. Ass'n*, Comm. Fut. Law. Rep. ¶ 21,726, at 27,288 n.2); *accord CFTC v. Enron Corp.*, 2004 WL 594752, at *6 (S.D. Tex. Mar. 10, 2004).
[122] *Parnon Energy*, 875 F. Supp. 2d at 244; *cf. CFTC v. Donald R. Wilson & DRW Invs., LLC*, 13-cv-07884, at *15-25 (S.D.N.Y. Nov. 30, 2018) (rejecting CFTC's contention that "intent is the transformative element for market manipulation" and that artificial price could be proven merely by showing that defendants intended to affect the price by making electronic bids); Moore & Wiseman, *supra*, p. 48 ("Before market quotations can be accepted as an accurate appraisal of a security, the market must be free and open, both in the sense of liquidity-the continuous operations of buyers and sellers, and in the sense that price is honestly chancered. To effect the latter, buyers and sellers must have adequate financial information 2 and the opportunity to trade on an unrigged market.").
[123] *Amaranth*, 587 F. Supp. 2d at 534.
[124] *In re Energy Transfer Partners Natural Gas Litig.*, 2009 WL 2633781, at *5 (S.D. Tex. Aug. 26, 2009).
[125] *Ind. Farm Bureau*, 1982 WL 30249, at *6; *In Re Hohenberg Bros.*, 1977 WL 13562, at *7 (CFTC Feb. 18, 1977) ("Intent is a subjective factor and since it is impossible to discover an attempted manipulator's state of mind, intent must of necessity be inferred from the objective facts and may, of course, be inferred by a person's actions and the totality of the circumstances.").
[126] *CFTC v. Wilson*, 27 F. Supp. 3d 517, 531 (S.D.N.Y. 2014).

element addressing defendants' ability to influence prices."[127] "It is enough, for purposes of a finding of manipulation in violation of [§ 9(a)(2) of the CEA] that defendant's action contributed to the price [movement]."[128]

E. Manipulation Involving Cryptocurrencies

Regulation of cryptocurrencies in the U.S. is still evolving, and whether they fall within the jurisdiction of the SEC, CFTC, or another regulator is generally determined on a case-by-case basis.[129] Thus, "[u]ntil Congress clarifies the matter, the CFTC has concurrent authority, along with other state and federal administrative agencies, and civil and criminal courts, over dealings in virtual currency."[130] Federal criminal cases involving cryptocurrencies are within the exclusive jurisdiction of the DOJ.[131] Cryptocurrencies are also regulated by the Treasury Department's Financial Enforcement Network (FinCEN), the IRS, and state regulators.[132]

The SEC's position is that its regulatory authority extends to any digital asset that constitutes a "security," defined by the Supreme Court as "an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."[133] To determine whether a cryptocurrency falls within this definition, courts examine their underlying substance (rather than their form). If a digital asset is determined to be a security, it must be registered with the SEC and offered pursuant to the SEC's registration requirements.[134]

If a particular cryptocurrency is deemed to be a commodity, on the other hand, it falls under the CEA and the jurisdiction of the CFTC,[135] and "[l]anguage in 7 U.S.C. § 9(1) ad 17 C.F.R. § 180.1 establish the CFTC's regulatory authority over manipulative schemes, fraud, and misleading statements" involving

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[127] *Wilson*, 27 F. Supp. 3d at 535 (citing *Parnon*, 875 F. Supp. 2d at 248; *In re Soybean Futures Litig.*, 892 F. Supp. 1025, 1045 (N.D. Ill. 1995).

[128] *Parnon Energy*, 875 F. Supp. 2d at 244; *In re Cox*, 1987 WL 106879, at *12 (holding that a charge of manipulation can be sustained where respondents' acts are a proximate cause of the artificial price).

[129] *See* T. Gorman, *Blockchain, Virtual Currencies and the Regulators*, Dorsey & Whitney LLP, Jan. 11, 2018 ("As the CFTC recently admitted, U.S. law does not provide for 'direct comprehensive U.S. regulation of virtual currencies. To the contrary a multi-regulatory approach is being used.").

[130] *CFTC v. McDonnell*, 287 F. Supp. 3d 213, 216 (E.D.N.Y. 2018).

[131] *See, e.g.*, *United States v. Faiella*, 39 F. Supp. 3d. 544, 545 (S.D.N.Y. 204) ("Defendants in this case are charged in connection with their operation of an underground market in the virtual currency 'Bitcoin' via the website 'Silk Road.'"); *United States v. Lord*, 2017 WL 1424806, at *2 (W.D. La. Apr. 20, 2017) ("Counts 2-14 charged Defendants with various crimes associated with operating their bitcoin exchange business.")

[132] *See McDonnell*, 287 F. Supp. 3d at 217.

[133] *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946); *see also SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943) ("Novel, uncommon, or irregular devices, whatever they appear to be are also reached if it be proved as a matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as 'investment contracts.'").

[134] *See, e.g.*, *SEC v. Plexcorps*, 2017 WL 5988934 (E.D.N.Y. Dec. 1, 2017) ("This is an emergency action to stop Lacroix, a recidivist securities law violator in Canada . . . from further misappropriating investor funds illegally raised through the fraudulent and unregistered offer and sale of securities called 'PlexCoin' or 'PlexCoin Tokens' in a purported 'Initial Coin Offering.'").

[135] *McDonnell*, 287 F. Supp. 3d at 217 ("A 'commodity' encompasses virtual currency both in economic function and in the language of [7 U.S.C. § 1(a)(9)]. CFTC's broad authority extends to fraud or manipulation in derivatives markets and underlying spot markets. CFTC may exercise its enforcement power over fraud related to virtual currencies sold in interstate commerce.").

cryptocurrencies.[136] Heath Tarbert, the outgoing CFTC Chairman, specifically identified two cryptocurrencies—Bitcoin and Ether—as commodities under the CFTC's jurisdiction: "We've been very clear on bitcoin: bitcoin is a commodity under the [CEA]. We haven't said anything about Ether – until now. It is my view as Chairman of the CFTC that Ether is a commodity, and therefore will be regulated under the CEA."[137]

In 2018, it was reported that the CFTC and DOJ had launched an investigation into possible manipulation in the crypto market. According to the Wall Street Journal, the investigation was prompted by the launch of Bitcoin (BTC) Futures by CME Group in December 2017. The price of CME's BTC Futures are based on data from four major crypto exchanges (Bitstamp, Coinbase, itBit and Kraken). It was speculated that authorities were probing whether prices on these exchanges were being manipulated through spoofing, wash sales, or other means in order to artificially influence BTC Futures. On August 5, 2018, the Journal published a report that found that "dozens of trading groups are manipulating the price of cryptocurrencies on some of the largest online exchanges, generating at least $825 million in trading activity over the past six months—and hundreds of million in losses for those caught on the wrong side."[138] The report identified 175 "pump and dump" crypto schemes involving anonymous online chat groups with names like "Big Pump Signal."

To date, no enforcement action stemming from the Journal report has been made public, but the CFTC has since filed a number of unrelated lawsuits involving cryptocurrencies, as has the SEC.[139]

F. Extraterritorial Application of U.S. Market Manipulation Regulations

"Absent clearly expressed congressional intent to the contrary, federal laws will be construed to have only domestic application."[140] Put simply, "[w]hen a statute gives no clear indication of extraterritorial application it has none."[141] To determine whether this presumption is rebutted, courts analyze federal statutes under a "two-step framework" that begins with consideration of "whether the statute gives a clear, affirmative indication that it applies extraterritorially."[142]

Because none of the anti-manipulation statutes above explicitly apply to conduct overseas, the extent of their extraterritorial reach turns on a step-two analysis which asks "whether the case involves a domestic application of the statute." This question is answered by determining the statute's "focus." "The focus of a statute is 'the object of its solicitude,' which can include the conduct it 'seeks to regulate'

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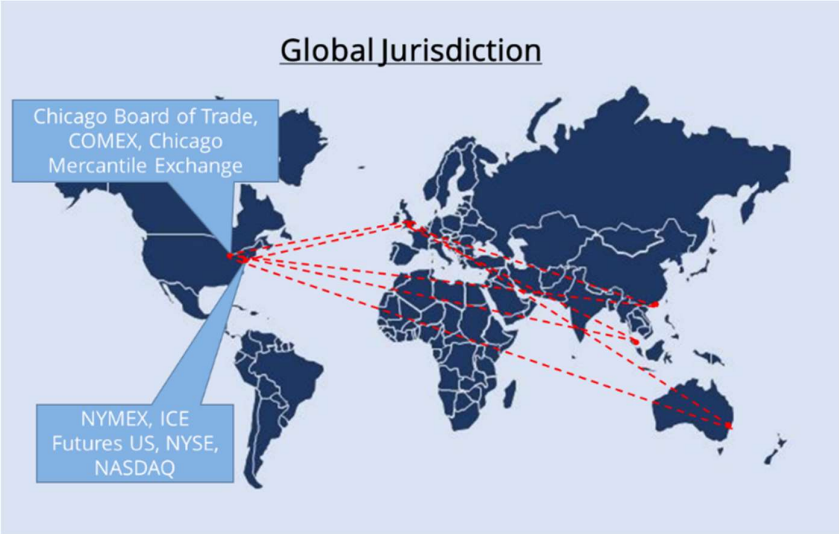
[136] *Id.* at 228; *see also CFTC v. My Big Coin Pay, Inc.*, 334 F. Supp. 3d 492, 493-94 (D. Mass. 2018) (rejecting argument that CFTC lacked jurisdiction over cryptocurrencies).
[137] CFTC Release Number 8051-19 (Oct. 10, 2019).
[138] Paul Vigna and Shane Shifflett, *Traders are Talking Up Cryptocurrencies, Then Dumping Them, Costing Others Millions*, WALL STREET JOURNAL (Aug. 5, 2018).
[139] *See, e.g.*, *CFTC v. 1Pool Ltd.*, 2019 WL 1605201 (D.D.C. Mar. 4, 2019); *CFTC v My Big Coin Pay, Inc.*, 334 F. Supp. 3d 492 (D. Mass. Sept. 26, 2018); *SEC v. Ackerman*, 20-cv-00181 (S.D.N.Y.); *SEC v. McAfee*, 20-cv-08281 (S.D.N.Y.).
[140] *RJR Nabisco, Inc. v. European Cmty,* 136 S. Ct. 2090, 2100 (2016).
[141] *Morrison v. National Australia Bank Ltd.*, 561 U.S. 247, 255 (2010).
[142] *Id.*

as well as the parties and interests it 'seeks to protect' or vindicate."[143] "If the conduct [at issue] relevant to the statute's focus occurred in the United States, then the case involves a permissible domestic application of the statute, even if other conduct occurred abroad. . . . But if the relevant conduct occurred in another country, then the case involves an impermissible extraterritorial application regardless of any other conduct that occurred in U.S. territory."[144] Since a "market manipulation claim . . . cannot be based solely upon misrepresentations or omissions," the "focus" of illegal manipulation is the market activity itself.[145]

As described in detail below, the presumption against extraterritoriality acts as a limited check on U.S. law enforcement's ability to bring cases involving foreign conduct. Even minimal contact with the U.S., such as communications or transactions within or through the U.S., is generally sufficient to bring otherwise foreign conduct within the purview of U.S. law. In practice, this makes traders situated anywhere in the world potentially subject to U.S. law enforcement's essentially global jurisdiction. In fact, a large percentage of recent market manipulation and spoofing cases have involved defendants in London, Hong Kong, Singapore, Sydney, Dubai, and elsewhere who traded on one of the major U.S. exchanges.



1. Exchange Act § 10(b) and Rule 10b-5

In its 2010 *Morrison* decision, the Supreme Court concluded that § 10(b) and Rule 10b-5 have only a domestic reach, and therefore apply only to one of two types of transactions: (1) "transactions in securities listed on domestic exchanges," and (2) "domestic transactions in other securities."[146] Days

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[143] *WesternGeco LLC v. ION Geophysical Corp.*, 138 S. Ct. 2129, 2137 (2018) (quoting *Morrison v. National Australia Bank Ltd.*, 561 U.S. 247, 267 (2010).
[144] *Id.*; *see also United States v. McLellan*, No. 18-2032, at *52 (1st Cir. May 20, 2020) ("A statute is applied domestically 'if domestic conduct satisfies every essential element to prove a violation . . . even if some further conduct contributing to the violation occurred outside the United States.'").
[145] *ATSI*, 493 F.3d at 101.
[146] *Morrison*, 561 U.S. at 267.

after this ruling, however, Congress inserted a provision, Section 929P(b) (15 U.S.C. § 78aa(b)), into Dodd-Frank that appeared to nullify *Morrison* in the context of SEC and DOJ actions under the Exchange Act. Section 929P(b) states:

> The district courts of the United States . . . shall have jurisdiction of an action or proceeding brought or instituted by the [SEC or DOJ] alleging a violation of the antifraud provisions of [the Exchange Act] involving—
>
> (1) Conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; or
> (2) Conduct occurring outside the United States that has a foreseeable substantial effect within the United States.

While the intended effect of Section 929P(b) seems clear, it has generated confusion in the lower courts because it addresses extraterritoriality as a jurisdictional issue, whereas *Morrison* clearly held it be a merits question.[147] As the Northern District of Illinois stated, for example, "The plain language of Section 929P(b) and its placement in the jurisdictional section of the Exchange Act indicate that it may be jurisdictional. It is unclear, however, whether the Court's analysis should stop there because it is possible that this interpretation would create superfluity or contradict the legislative intent."[148]

In 2019, the Tenth Circuit became the first court of appeals to hold that Section 929P(b) did in fact abrogate *Morrision*, and that the Exchange Act's substantive anti-fraud provisions should apply outside the U.S. as long as the conduct had either a foreseeable effect in the U.S. or on U.S. citizens, or occurred in the U.S.[149]

Outside the Tenth Circuit, courts continue to apply the test in *Morrison* in both civil and criminal fraud cases.[150] For example, in 2014, the Second Circuit considered whether this test's first prong allowed suits involving foreign investors, foreign defendants, and shares purchased on a foreign exchange.[151] Even though the shares at issue were cross-listed on the NYSE, the court held that *Morrison* precluded application of U.S. law unless the shares were actually purchased on a U.S. exchange. As to the second prong, another Second Circuit decision concluded a transaction will be considered "domestic" if "irrevocable liability is incurred or title passes within the United States."[152] "Irrevocable liability" attaches "when the parties to the transaction are committed to one another," or, "in the classic contractual sense, there was a meeting of the minds of the parties."[153]

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[147] *Id.* at 254.
[148] *SEC v. Chicago Convention Ctr. LLC*, 961 F. Supp. 2d 905, 911 (N.D. Ill. 2013).
[149] *SEC v. Scoville*, 913 F.3d 1204, 1218 (10th Cir. 2019); *see also SEC v. Traffic Monsoon, LLC*, 245 F. Supp. 3d 1275 (D. Utah 2017) (also concluding that Section 929P(b) overruled *Morrison*).
[150] *United States v. Vilar*, 729 F.3d 62, 72 (2d Cir. 2013) (finding *Morrison* applies equally to the civil and criminal contexts).
[151] *City of Potiac Policemen's & Firemen's Ret. Sys. v. UBS AG*, 752, F.3d 173, 179-90 (2d Cir. 2014).
[152] *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 677 F.3d 60, 67 (2d Cir. 2012).
[153] *Id.*

How this formula applies to complex cross-border transactions involving quasi-domestic instruments like American depositary receipts remains an open question.[154]

2. Commodity Exchange Act

The *Morrison* decision and Section 929P(b) applied only to the federal securities laws (the 1933 Securities Act and 1934 Exchange Act). The extraterritorial reach of enforcement actions brought under the CEA continue to be assessed under the pre-*Morrison* "conduct and effects" test, which asked: (i) "whether the wrongful conduct had a substantial effect in the U.S. or upon U.S. citizens," and (ii) "whether the wrongful conduct occurred in the U.S."[155] Because of this, the CFTC has asserted that they can bring enforcement actions against manipulation that has some effect on U.S. commodities markets and prices, even if the defendant did not actually transact through a U.S. exchange.[156]

The Second Circuit, however, has pushed back on this expansive interpretation. In the 2019 *Prime Int'l Trading* decision, the Second Circuit concluded that the CEA's antifraud and antimanipulation provisions have no extraterritorial application.[157] Plaintiffs in that case were traders of crude oil futures and derivatives contracts on NYMEX who sued companies who produce crude oil in the North Sea. Plaintiffs claimed that defendants had traded physical crude in Europe in order to manipulate related benchmark and futures prices in the U.S. In affirming the district court's dismissal of the complaint, the Second Circuit concluded that the CEA requires not only domestic transactions, "but also domestic—not extraterritorial—*conduct* by defendants that is violative of a substantive provision of the CEA."[158]

While *Prime Int'l Trading* involved private plaintiffs, it is likely that, at least in the Second Circuit, the same analysis would be applied to DOJ and CEA enforcement actions. This could make it more difficult for regulators to pursue CEA violations involving manipulative conduct occurring entirely overseas and/or predominantly affecting futures and derivatives traded abroad.

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[154] *Compare Parkcentral Global Hut Ltd. v. Porsche Auto Holdings SE*, 763 F.3d 198 (2d Cir. 2014) *with Stoyas v. Toshiba Corp.*, 763 F.3d 933 (9th Cir. 2018).
[155] *SEC v. Berger*, 322 F.3d 187, 192-93 (2d Cir. 2003).
[156] Br. For Amicus Curiae CFTC, *Prime Int'l Trading*, 17-2233 (2d Cir.), Dkt. # 148 at 22-23.
[157] *Prime Int'l Trading, Ltd. v. BP p.l.c.*, 937 F.3d 94 (2d Cir. 2019), *reh'g and reh'g en banc denied*, 17-2233 (2d Cir. Oct. 16, 2019).
[158] *Id.* at 107.

III. MARKET MANIPULATION IN THE U.K.

Anti-manipulation regulations in the U.K. stem mainly from the E.U.'s Market Abuse Regulation (MAR) No 596/2014, which came into effect in 2016 while the U.K. was still an E.U. member (and therefore continues to has direct application in Britain). MAR was incorporated into U.K. domestic law through amendments made to the Financial Services and Markets Act 2000 (FSMA) and the Financial Services Act 2012 (FSA), and is therefore unaffected by Brexit. Market manipulation can also be targeted with the Fraud Act 2006 (FA) and the Regulation on Wholesale Energy Market Integrity and Transparency (REMIT).

The regulators with primary responsibility over enforcing these laws are the Financial Conduct Authority (FCA), which brings mainly civil enforcement actions, and the Serious Fraud Office (SFO), which focuses on criminal prosecutions, and the Office of Gas and Electricity Markets (Ofgem), which regulates energy markets.

A. Structure of U.K. Market Regulators

Jurisdiction: global
Remit: criminal and civil enforcement of FSMA, FSA, FA, REMIT
Financial Instruments Covered: OTC and exchange traded
Investigatory Arm: Enforcement Division

Jurisdiction:
Remit: criminal prosecution of sophisticated economic crimes
Financial Instruments: OTC and exchange traded
Investigatory Arm: in-house investigators, Metropolitan Police, National Crime Agency

Jurisdiction: trading in U.K. energy markets
Remit: civil regulation of REMIT
Financial Instruments Covered: exchange traded
Investigatory Arm: in-house investigators

B. E.U.'s Market Abuse Regulation

MAR broadly applies to all financial instruments traded on a regulated market, a multilateral trading facility, and an organised trading facility. It also applies to financial derivative instruments not traded on a formal trading facility (*i.e.*, OTC instruments) whose "price or value depends on or has an

effect on the price or value of a financial instrument [traded on a facility], including, but not limited to, credit default swaps and contracts for difference."[159]

MAR Article 15 makes it an offense to engage or attempt to engage in prohibited market manipulation activities. Article 12 defines market manipulation to include:

- "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;"

- "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;"

- "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 behavior which manipulates the calculation of a benchmark;"

- "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 [a manipulative effect], by:

    - Disrupting or delaying the functioning of the trading system of the trading venue or being likely to do so;

    - 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

    - 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."

Per FSMA § 123, the FCA may impose a civil penalty on any individual found to have engaged in any of the conduct specified in MAR Article 15. The FCA can also apply to the High Court for an injunction restraining an actual or likely Article 15 violation. Because the U.K. declined to adopt a follow-on E.U. regulation specifying criminal penalties for market manipulation, MAR violations are subject to civil penalties only.[160]

Unlike its equivalent in U.S. law, MAR gives market participants certain affirmative defenses to market manipulation. Under Article 13, a person or entity will not be liable for market manipulation if

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[159] FCA, "Market Abuse Regulation," https://www.fca.org.uk/markets/market-abuse/regulation. A "contract for difference" (CFD) is an "an agreement between a customer and a financial institution where the difference in the value of a specified asset at the beginning and end of the contract is exchanged." CFDs are roughly equivalent to a futures contract in the U.S.

[160] The provisions of MAR were supplemented by the Directive on Criminal Sanctions for Market Abuse (2014/57/EU) and Regulation (EU) No 596/2014. Together, these provisions specify criminal penalties applicable to market manipulation and insider dealing, and strengthen national regulators' investigative powers to detect abuses on financial markets. Since these provisions were scheduled to take effect in July 2016, after the U.K.'s vote to leave the E.U., they were not incorporated into U.K. law and therefore will not be considered in this overview.

they can establish that the "transaction, order or behaviour" at issue was "carried out for legitimate reasons, and conform[s] with an accepted market practice."

C. Financial Services Act 2012

Whereas FSMA includes only civil penalties for market manipulation, FSA Part 7 allows for such cases to be penalized criminally. The two FSA sections pertaining to market manipulation are Sections 89 and 90.

Section 89 ("Making misleading statements") makes it "an offense 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 offense is committed if a person (i) knowingly makes a false or misleading statement, (ii) is reckless as to whether his conduct may fraudulently induce another to transact, or (iii) dishonestly conceals material facts.

Section 90 ("Misleading impressions") makes it "an offense 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 instruments." The offense is committed if a person intends to make the impression and intends either to (i) induce another person to acquire, dispose of, subscribe for the investments, or (ii) to make a gain for himself or cause loss to another or to be aware that it is likely to have that result.

An offense under these sections carries a maximum punishment of seven years' imprisonment and/or an unlimited fine.

D. FCA Handbook

The FCA has published guidance that provides additional details on the types of behaviour likely to be flagged as illegally manipulative.[161] In comparison with similar guidance published by the CFTC, the FCA's is much more comprehensive and specific.

The FCA Handbook notes, for example, that the following conduct involves "false or misleading impressions" to other market participants:

- Buying or selling at the close of market with the effect of misleading investors who act on the basis of closing prices, "other than for legitimate reasons."

- "Wash trades"—*i.e.*, sales or purchases where there is no change in beneficial interest or market risk, or where the transfer of beneficial interest or market risk is only between parties acting in concert or collusion, "other than for legitimate reasons."

- "Painting the tape"—*i.e.*, entering into a series of transactions for the purpose of giving the impression of activity or price movement.

- Entering orders at prices which are higher than the previous bid or lower than the previous offer, and withdrawing them before they are executed, in order to give a misleading impression that there is demand or supply at that price.

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[161] FCA Handbook, *available at* https://www.handbook.fca.org.uk/handbook/MAR/1/6.html?date=2016-03-07.

1. What's a "Legitimate Reason"?

Per the above, certain market activity that may be facially manipulative can be permissible as long as it is done for a "legitimate reason." While the Handbook does not expressly define this term, it does list the factors that indicate conduct is not for a legitimate reason:

- If the trader "has an actuating purpose behind the transaction to induce others to trade in, bid for or to position or move" prices.
- If the trader "has another, illegitimate, reason behind the transactions, bid or order to trade."
- "If the transaction was executed in a particular way with the purpose of creating a false or misleading impression."

The Handbook also lists the factors FCA considers indicative of legitimately entered orders:

- "If the transaction is pursuant to a prior legal or regulatory obligation owed to a third party."
- "If the transaction is executed in a way which takes into account the need for the market or auction platform as a whole to operate fairly and efficiently."
- "The extent to which the transaction generally opens a new position, so creating an exposure to market risk, rather than closes out a position and so removes market risk."
- If the transaction complied with the rules of the relevant market about how transactions are to be executed.

2. What's a "False or Misleading Impression"?

As in US law, UK market manipulation regulations are concerned with market activities that are likely to misleading other traders. But since nearly all sophisticated market participants routinely engage in strategies specifically designed to conceal their trading interest (and therefore mislead others about the true extent of supply or demand), what exactly constitutes an improperly "false" impression is somewhat unclear.

In the FCA's view, the following factors are relevant to this determination:

- "The extent to which orders . . . or transactions represent a significant proportion of the daily volume of transactions in the relevant [asset or instrument], in particular when these activities lead to a significant change in the price."
- "The extent to which orders . . . or transactions undertaken by persons with a significant buying or selling position . . . lead to significant changes in the price of an [security] or related derivative or underlying asset."
- "Whether transactions undertaken lead to no change in beneficial ownership."
- "The extent to which orders . . . or transactions include position reversals in a short period and represent a significant proportion of the daily volume of transactions" "and might be associated with significant changes in the price."

- "The extent to which orders . . . or transactions are concentrated within a short time span in the trading session and lead to a price change which is subsequently reversed."

- "The extent to which orders . . . change the representation of the best bid or offer prices . . ., or more generally the representation of the order book available to market participants, and are removed before they are executed."

- "The extent to which orders . . . or transactions are undertaken at or around a specific time when reference prices, settlement prices and valuations are calculated and lead to price changes which have an effect on such prices and valuations."

E. Fraud Act 2006

Under section 2 of the Fraud Act 2006, it is an offence for a person to "dishonestly" make a "false representation," if they intend, by making the representation, to make a gain for themselves or another, or cause loss to another or expose another to a risk of loss. As set forth in Ivey v Genting Casinos (UK) (trading as Cockfords Club) [2017] UKSC 67, "dishonesty" under section 2 is determined through an objective test that assesses whether a defendant has been dishonest by the standards of an ordinary, reasonable individual with the same knowledge or belief as to the relevant facts. 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. A "representation" may be express or implied and may be regarded as made if it is submitted in any form to any system or device designed to receive, convey or respond to communications (with or without human intervention). A section 2 offense is punishable by a maximum punishment of seven years' imprisonment and/or an unlimited fine.

F. Regulation on Wholesale Energy Market integrity and Transparency

The Regulation on Wholesale Energy Market integrity and Transparency (REMIT) is an EU regulation on energy market integrity and transparency. The law came into force in December 2011 (pre-Brexit) and continues to provide a regulatory framework for identifying and penalising market abuse on UK wholesale energy markets. In the U.K., REMIT is enforced by the FCA and the Office of Gas and Electricity Markets (Ofgem).

Article 5 of REMIT prohibits engaging in, or attempting to engage in, wholesale energy markets. Article 2 of REMIT defines market manipulation as:

(a) entering into any transaction or issuing any order to trade in wholesale energy products which:

(i) gives, or is likely to give, false or misleading signals as to the supply of, demand for, or price of wholesale energy products;

(ii) secures or attempts to secure, by a person, or persons acting in collaboration, the price of one or several wholesale energy products at an artificial level, unless the person who entered into the transaction or issued the order to trade establishes that his reasons for doing so are legitimate and that that transaction

or order to trade conforms to accepted market practices on the wholesale energy market concerned; or

(iii) employs or attempts to employ a fictitious device or any other form of deception or contrivance which gives, or is likely to give, false or misleading signals regarding the supply of, demand for, or price of wholesale energy products.

G. "Spoofing" in the U.K.

As in the U.S., U.K. regulators consider spoofing to be a form of market manipulation whereby a trader places visible non-bona fide orders with the intention to deceive and affect the market price without an intention to execute them. However, there is no statute in Britain that specifically prohibits spoofing by name. Instead, spoofing can be targeted under the relevant provisions of MAR, FSA, FA, or REMIT discussed above.

For cases alleging civil violations of these laws, regulators must prove that the trader's behaviour created a false or misleading impression in the market (regardless of their intent). In a criminal case, it must be proved that the trader acted with criminal intent and that their behaviour had an actual false or misleading effect on the market. These standards are similar to those applicable to pre-Dodd Frank manipulation actions by the CFTC, and are therefore more stringent than what regulators in the U.S. must prove.

To date, there have been no criminal prosecutions in the U.K. for spoofing. But there have been a number of civil actions targeting spoofing:

Defendant	Prosecuting Authority	Case Details
2020		
Engie Global Markets	Ofgem	Engie Global Markets imposed a €2.3 million fine for manipulative spoofing on the wholesale gas markets.
Corrado Abbattista	FCA	The FCA imposed a £100,000 fine against Corrado Abbattista, a trader at Fenician Capital Management LLP in London, for market abuse.
2019		
Engie Global Markets	Ofgem	Ofgem found that Engie Global Markets (EGM) has breached Article 5 (prohibition on market manipulation) of the REMIT. After a suspicious activity alert, Ofgem found that, between 1 June 2016 and 31 August 2016, a trader working in the name, and on behalf, of EGM, contravened Article 5 of REMIT on a number of occasions by engaging in "spoofing". Ofgem noted EGM's full co-operation with the investigation and recognises EGM has admitted it breached Article 5 of REMIT and agreed to settle early. EGM therefore qualified for a 30% discount for early settlement and Ofgem considered it appropriate to impose a reduced fine of £2,128,236.00.
2013		
Michael Coscia	FCA	The FCA imposed upon Michael Coscia, a US-based trader, a financial penalty of $903,176 (approximately £600,000) pursuant to section 123(1) of FSMA for engaging in market abuse. The FCA accused Coscia of engaging in layering over a six-week period in 2011 on the ICE Futures Europe Exchange in London.
2011		

Defendant	Prosecuting Authority	Case Details
Swift Trade Inc	FCA	The FCA imposed upon Swift Trade Inc a financial penalty of £8,000,000 for engaging in market abuse by spoofing. The company unsuccessfully appealed the case to the UK's Upper Tribunal and the Court of Appeal, after which a final penalty was imposed in 2014.
Da Vinci Invest Ltd, et al.	FCA	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.

H. Manipulation Involving Cryptocurrencies

As in the U.S., clamping down on manipulation involving cryptocurrencies is a key priority of regulators in the U.K. In a 2019 statement, for example, the FCA said, "A combination of market immaturity, volatility, and a lack of credible information or oversight raises concerns about market integrity, manipulation and insider dealing within cryptoasset markets."[162] Cryptocurrencies are seen as particularly susceptible to manipulative schemes for at least four reasons. First, cryptocurrency exchanges are relatively new and most have yet to implement formal policies against manipulation or adopt adequate market surveillance methods to detect manipulation. Second, because crypto exchanges' profitability turns on the volume of trades they process, there is a financial incentive to turn a blind eye to manipulation (so as not to drive trading elsewhere). Third, since cryptocurrencies are a relatively new and still-developing phenomenon, law enforcement agencies have yet to develop the investigatory tools to effectively monitor crypto trading. And lastly, cryptocurrencies are by design anonymous, making it more difficult to trace manipulative activity to any particular actor.[163]

Despite the inherent risk of crypto manipulation, the FCA has determined that its existing rules do not apply to Bitcoin, Ethereum or similar currencies because they are not listed as a regulated activity in the Financial Services and Markets Act 2000 Order. However, derivative instruments based on cryptocurrencies do arguably fall under existing MAR regulations, but there have been no MAR regulatory actions targeting crypto in the U.K. to date. The FCA is currently working with Britain's finance minister to create a more definitive framework for crypto regulation in the near future.

I. Extraterritorial Application

The law of England & Wales requires offenses to be tried only in the jurisdiction in which they take place, unless there is a specific provision to ground jurisdiction in the relevant statute. For offenses that may multiple jurisdictions, the common law position is that the offense must have a "substantial connection" to England or Wales in order for their courts to have jurisdiction. As such, where a substantial number of the activities constituting a crime takes place within England or Wales, courts in

[162] Huw Jones & Tom Wilson, "UK watchdog warns of perils of unregulated cryptocurrencies," REUTERS (July 31, 2019).
[163] Anirudh Dhawan & Talis Putnins, *A new wolf in town? Pump-and-dump manipulation in cryptocurrency markets* (Nov. 17, 2020), https://ssrn.com/abstract=3670714.

these countries have jurisdiction unless it can be argued, on a reasonable view, that that the conduct ought to be dealt with by the courts of another country.[164]

While this rule is similar to the *Morrison* "conduct and effects" test used in the U.S., in practice, the extraterritorial reach of U.K. domestic law is much more limited than in the U.S. and U.K. regulators have shown far greater reluctance to target overseas defendants for market manipulation offenses.

[164] R v Smith (Wallace Duncan) (No. 4) [2004] 3 WLR 229, per Lord Chief Justice Woolf.

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