UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

UNITED STATES OF AMERICA, v. JITESH THAKKAR, Defendant.	Case No. 18-CR-36 Judge Robert W. Gettleman

DEFENDANT JITESH THAKKAR'S MOTION TO DISMISS THE INDICTMENT WITH PREJUDICE OR, IN THE ALTERNATIVE, FOR *IN CAMERA* REVIEW OF THE GRAND JURY TRANSCRIPT AND TO STRIKE PREJUDICIAL LANGUAGE FROM THE INDICTMENT

Defendant Jitesh Thakkar hereby moves to dismiss the indictment with prejudice or, in the alternative, moves for an *in camera* review of the grand jury transcript and to strike prejudicial language from the indictment. In support thereof, Jitesh states as follows:

1. The indictment charges Jitesh with conspiracy to commit spoofing (Count I) and aiding and abetting spoofing (Counts II & III).

2. As explained in the accompanying memorandum, the charges in the indictment are void for vagueness and should be dismissed. In addition, the aiding and abetting counts of the indictment are untimely and should be dismissed because they are beyond the statute of limitations.

3. If the Court does not dismiss the indictment in its entirety, for the reasons set forth in the accompanying memorandum, Jitesh requests that the Court undertake an *in camera* review of the grand jury transcript in this case to determine if the government prejudiced the jury by discussing "market manipulation" as an "example" of spoofing and strike the prejudicial surplusage related to this "example" from the indictment.

WHEREFORE, Defendant Jitesh Thakkar respectfully requests that this Court dismiss the indictment with prejudice or, in the alternative, review the grand jury transcript *in camera*, and strike prejudicial language from the indictment.

Respectfully submitted,
THOMPSON COBURN, LLP

By: /s/ *Renato Mariotti*

Renato Mariotti
Holly H. Campbell
THOMPSON COBURN LLP
55 East Monroe St., 37th Floor
Chicago, Illinois 60603
(312) 346-7500
rmariotti@thompsoncoburn.com
hcampbell@thompsoncoburn.com

Attorneys for Jitesh Thakkar

CERTIFICATE OF SERVICE

The undersigned hereby certifies that he electronically filed the foregoing **Jitesh Thakkar's Motion to Dismiss the Indictment with Prejudice, or in the Alternative, For *In Camera* Review of the Grand Jury Transcript and to Strike Prejudicial Language from the Indictment** with the Clerk of the Court on May 29, 2018, using the CM/ECF system, which sent notification of such filing to all counsel of record in this matter.

/s/ Renato Mariotti

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
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UNITED STATES OF AMERICA, v. JITESH THAKKAR, Defendant.	Case No. 18-CR-36 Judge Robert W. Gettleman

MEMORANDUM OF LAW IN SUPPORT OF DEFENDANT JITESH THAKKAR'S MOTION TO DISMISS THE INDICTMENT WITH PREJUDICE OR, IN THE ALTERNATIVE, FOR *IN CAMERA* REVIEW OF THE GRAND JURY TRANSCRIPT AND TO STRIKE PREJUDICIAL LANGUAGE FROM THE INDICTMENT

Renato Mariotti
Holly H. Campbell
THOMPSON COBURN LLP
55 East Monroe St., 37th Floor
Chicago, Illinois 60603
(312) 346-7500
rmariotti@thompsoncoburn.com
hcampbell@thompsoncoburn.com

Attorneys for Jitesh Thakkar

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INTRODUCTION

In this case, the government stretches the recently enacted "spoofing" statute far further than it ever has before, charging the owner of a small software company with "aiding" and "conspiring with" a trader who used software created by the company years later to trade in the financial markets. The government charged the owner, Jitesh Thakkar, despite declining to charge computer programmers who actively knew about manipulative trading and personally created programs to enable it. In doing so, the government violated the constitutional prohibition against arbitrary enforcement, and this indictment must be dismissed. Moreover, in order to bring these unprecedented charges, the government reached far beyond the applicable statute of limitations to allege that Jitesh aided and abetted trader Navinder Sarao in placing spoof orders, which is another reason the aiding and abetting counts must be dismissed.

In the event this Court does not dismiss the indictment in its entirety, this Court should strike language from the indictment containing an irrelevant, misleading, and prejudicial "example" of how spoofing "could be used" and undertake an *in camera* review of the grand jury proceedings to determine if the government misled the grand jury about the crimes Jitesh was charged with by using this "example." Indictments and the presentation to the grand jury should consist of allegations about the *defendant's* conduct, not "examples" of conduct by hypothetical individuals included to confuse and inflame the jury.

BACKGROUND

Jitesh Thakkar is the owner of Edge Financial Technologies, a small software company in Chicago. Indictment ¶ 1. After working in technology roles for other companies for many years, Jitesh decided to start his own business to provide technology consulting and custom products to the financial industry. Since opening his business in 2007, Jitesh and Edge Financial have provided a variety of products and services to a wide range of financial industry clients, including risk monitoring programs, back office technology integrations, and custom trading platforms. Edge Financial products, such as its "kill switch" product and risk response program, help companies meet their regulatory requirements and help reduce risks in the trading industry. *See* http://www.edgefinite.com/.

In October 2011, Navinder Sarao, a U.K.-based trader, was referred by a third party to Edge Financial for assistance in creating a customized trading program that Sarao formulated. *See* Indictment ¶¶ 14, 17. Before he received an unsolicited e-mail from Sarao in October 2011, Jitesh had never heard of Sarao. Sarao independently developed the concept for his custom trading program as early as January 2009, years before Jitesh first met Sarao. *Id.* In late 2011 and early 2012, Sarao sent the specifications for his trading program to Jitesh, who passed Sarao's program specifications on to the Edge Financial employees who developed the program. Between approximately November 2011 and January 2012, Edge Financial employees—not Jitesh—created a trading program for Sarao according to the specifications Sarao provided. *See, e.g., id.* at ¶ 19. Sarao did not explain his trading strategy or intended use for the program, which Jitesh views as a trader's propriety "secret sauce," to Jitesh during this development process.

In January 2012, Edge Financial delivered the trading program to Sarao based on Sarao's requirements. *See id.* at ¶ 28. Sarao represented himself as small-time trader to Jitesh and only paid Edge Financial a total of $24,200 for the trading program Edge Financial developed for Sarao. *Id.* at ¶ 34. Jitesh and Edge Financial did not receive any other payments or compensation from Sarao after receiving this $24,200 in 2012 for creating the program. Sarao later told the FBI he did not tell Jitesh the type of trader he was, because if he told Jitesh he was a successful trader, Jitesh may have charged Sarao more for the program. (The indictment alleges that Sarao made more than $1,000,000 in profit placing "spoof" orders. *Id.* at ¶ 32.)

After Edge Financial completed Sarao's program in 2012, Jitesh was selected to serve as a volunteer on the Commodity Futures Trading Commission's ("CFTC") Technology Advisory Committee Subcommittee on High Frequency Trading. *Id.* at ¶ 2. The Technology Advisory Committee "was created in 1999 to advise the [CFTC] on the impact and implications of technological innovations on financial services and the futures markets, and the appropriate legislative and regulatory response to increasing use of technology in the markets." *See https://www.cftc.gov/About/CFTCCommittees/TechnologyAdvisory/index.htm.* Although Jitesh had never personally engaged in trading, over the next three years, Jitesh contributed dozens of hours of his time to the Committee—learning about the Commodities Exchange Act ("CEA"), CFTC regulations, and trading; providing his technology expertise to the Committee; and engaging in discussions with Committee members about appropriate definitions and regulations related to high-frequency trading.

Around this same time, the CFTC was separately working to provide more clarity and guidance on the new "spoofing" prohibition that Dodd-Frank added to the CEA, and which commentators and industry experts described as "vague" and "not clearly defined." 7 U.S.C. 6c(a)(5)(C) (prohibiting "'spoofing' (bidding or offering with the intent to cancel the bid or offer before execution)"); *see also* Letter from John M. Damgard, President of FIA, at 1, 6-7 (Dec. 23, 2010), attached hereto as Exhibit A. In November 2010, the CFTC sought public comments on the "spoofing" provision of the statute. *See* 75 Fed. Reg. 67,301-01 (Nov. 2, 2010). The questions the CFTC invited and encouraged comment on included questions directed at clarifying and defining the broad language of the statute such as:

> 8. How should the Commission distinguish 'spoofing,' as articulated in paragraph (C), from legitimate trading activity where an individual enters an order larger than necessary with the intention to cancel part of the order to ensure that his or her order is filled?

> . . .
>
> 10. Does partial fill of an order or series of orders necessarily exempt that activity from being defined as 'spoofing'?
>
> 11. Are there ways to more clearly distinguish the practice of spoofing from the submission, modification, and cancelation of orders that may occur in the normal course of business?

Id. In 2011, the CFTC decided to prepare an Interpretive Order regarding the anti-disruptive practices authority in Dodd-Frank, including the "spoofing" provision, instead of moving forward with its proposed rulemaking. In March 2011, the CFTC published a non-binding proposed Interpretive Order providing a proposed interpretation of the "spoofing" provision. 76 Fed. Reg. 14,943-02 (March 18, 2011). Finally, in May 2013, more than 16 months after Jitesh delivered the program designed to Sarao's specifications that the government alleges Sarao used to place spoof trades (Indictment ¶ 28), the CFTC published its final Interpretive Order, which included guidance on and further definition of what constitutes "spoofing" under the CEA. 78 Fed. Reg. 31,890-01 (May 28, 2013). The final Interpretive Order provided that,

> [w]hen distinguishing between legitimate trading (such as trading involving partial executions) and 'spoofing,' the Commission intends to evaluate the market context, the person's pattern of trading activity (including fill characteristics), and other relevant facts and circumstances.

Id. It was not until more than a year after this guidance was released that the government first criminally charged an individual with spoofing in October 2014, and no civil charges for spoofing were brought prior to July 2013, 18 months after Edge Financial created the program for Sarao.

In September 2015, more than three years after Edge Financial delivered Sarao's program, the government indicted Sarao under the new spoofing statute, along with other crimes related to his trading activity. *See U.S.A. v. Navinder Sarao*, Case No. 15-cr-75. The Sarao indictment alleged that Sarao had worked with three other programmers in addition to Edge Financial to develop the trading program Sarao devised. The Sarao indictment alleged that Sarao contacted another programmer ("Programmer 1") to help him create his trading program years before he contacted Jitesh. *See* Sarao Indictment ¶¶ 11, 12. According to the Sarao indictment, Sarao told Programmer 1 that under certain circumstances, he would want to "spoof it [*i.e.*, the market] down[,]" that if he kept "entering the same clip sizes, people will become aware of what I am doing, rendering my spoofing pointless[,]" and that he wanted "to make it [the program] workable in terms of me moving the market like we discussed." *Id.* at ¶¶ 11, 12, 14. Sarao later told "Programmer 2" and "Programmer 3's" company that he wanted them to create a "cancel if close function" that would cause his "order [to] be pulled if there are not x amount of orders beneath it" and wanted to be able "to enter multiple orders at different prices using one click." *Id.* at ¶ 18.

Unbeknownst to Jitesh, Sarao had also apparently later used the program Edge Financial created for him to place spoof trades into the market. Jitesh was shocked by the Sarao indictment. The program Edge Financial created did not include any functionality to automatically cancel orders or pre-program orders to automatically cancel that would facilitate the placement of spoof orders. Instead, Sarao had apparently used the back of book function, which does not in itself constitute spoofing, in combination with other functionality and his own trading strategies to engage in spoofing. Jitesh had never traded himself and was not aware that Sarao would use the program Edge Financial created in this way to engage in "spoofing."

Sarao had never made any statements to Jitesh regarding his intended trading patterns or attempts to spoof or move the market like he did with Programmers 1-3. The indictment against Jitesh contains no allegations that Sarao ever told Jitesh that he planned to spoof, move the market, or engage in any other illegal activity, which is consistent with Sarao's FBI interview reports in which Sarao told the government that he did not tell Jitesh what he planned to do. This is also consistent with Sarao's indictment, which recounts Sarao's conversations about his intent to spoof with the other three programmers over five pages of the indictment, but only contains one reference to Jitesh: "In approximately late 2011, Sarao began working with [Jitesh], to further develop the automated trading programs and functions he had been working to design and implement since early 2009." *Id.* at ¶ 20.

Although the government indicted Sarao, it never prosecuted Programmers 1-3, who personally created a program to help Sarao spoof knowing Sarao intended to use the programs to place spoof orders. Instead, in January 2018, nearly six years after Edge Financial delivered the program that the government alleges Sarao used to place spoof orders (*id.* at 28), Jitesh was charged and arrested at his Naperville home in front of his wife and children. While awaiting his day in court to prove his innocence, Jitesh has continued to run Edge Financial, but the business has suffered irreparable reputational harm ever since the government brought these arbitrary and baseless charges.

DISCUSSION

I. THE SPOOFING STATUTE IS UNCONSTITUTIONALLY VAGUE AS APPLIED TO JITESH'S CONDUCT

The government's decision to bring conspiracy and aiding and abetting spoofing charges against the owner of a software company because a trader later used that software to spoof is unprecedented and the spoofing statute is unconstitutionally vague when applied to this conduct. A statute is void for vagueness on one of two independent grounds. A statute violates the Constitution if it: (1) authorizes "arbitrary and discriminatory enforcement" or (2) "fail[s] to provide the kind of notice that will enable ordinary people to understand what conduct it prohibits." *City of Chicago v. Morales*, 527 U.S. 41, 56 (1999). Applying spoofing-related charges to Jitesh's conduct violates both of these independent grounds for finding a statute void for vagueness, and this indictment must be dismissed.

A. Applying Spoofing-Related Charges to Jitesh's Conduct Exemplifies Arbitrary and Discriminatory Enforcement

Applying the spoofing statute to Jitesh's conduct is unprecedented—for the first time, the government seeks to hold the owner of a software company criminally liable for someone else's uses of his company's software years after he purchased the software. Prior to Jitesh's indictment, only three other individuals had ever been criminally charged with spoofing. Every other individual who has been criminally charged with spoofing was a trader who was alleged to have actually placed spoof orders into the market. Jitesh is the first and only individual ever charged with a crime related to the spoofing statute who did not engage in *any* trading activity.

Out of the handful of spoofing cases ever charged, only one has reached a Court of Appeals. *See United States v. Coscia*, 866 F.3d 782 (7th Cir. 2017), *reh'g and suggestion for reh'g en banc denied* (Sept. 5, 2017), *cert. denied*, No. 17-1099, 2018 WL 747023 (U.S. May 14, 2018). Although the Seventh Circuit rejected Coscia's argument that the spoofing statute's vagueness allows for arbitrary enforcement in that case, *Coscia* involved completely different circumstances that make the Court's analysis there inapplicable to this case. Coscia was a seasoned trader alleged to have placed over 450,000 spoof orders. *Id.* at 788. Coscia commissioned a trading program "designed to pump or deflate the market through the use of large orders that were *specifically designed* to be cancelled if they ever risked actually being filled." *Id.* at 794 (emphasis original). The Court found that because Coscia's behavior "clearly falls within the conduct prohibited by the statute" and fell "well within the core of the anti-spoofing provision's prohibited conduct," he could not claim that he was subject to arbitrary enforcement. *Id.* at 795. The Court also held that Coscia could not "challenge any allegedly arbitrary enforcement that could hypothetically be suffered by a theoretical legitimate *trader*." *Id.* at 794 (emphasis added). Further, the Court held that even if Coscia could challenge arbitrary enforcement, the intent requirement of the statute prevents arbitrary enforcement because "[c]riminal prosecution is thus limited to the pool of *traders* who exhibit the requisite criminal intent." *Id.* (emphasis added).

Unlike *Coscia*, Jitesh's alleged actions as the owner of a software company are far outside the core conduct that the spoofing statute intended to prohibit. Indeed, in its ruling in *Coscia*, the Seventh Circuit only discussed "traders" because it was hard for anyone to imagine that the government would try to stretch the statute to charge someone who wasn't a trader at all. In this case, Jitesh received program specifications from Sarao and passed those specifications along to his programmers, who developed the software according to Sarao's specifications. The program Edge Financial created for Sarao did not contain any functions to allow pre-programming or automatic cancellation of orders that could be considered to fall within the core of what the spoofing statute intends to prohibit. Unbeknownst to Jitesh, Sarao used the program's back of the book function, which alone do not constitute spoofing, in combination with other functions and his overall trading strategy to place spoof orders. As discussed above, Sarao never told Jitesh what his trading strategy entailed or how he intended to use the program Edge Financial developed for him. For this reason, Jitesh's conduct cannot be considered to be anywhere near the "core" conduct the spoofing statute intended to prohibit, and the government's application of the statute to his conduct constitutes arbitrary enforcement that violates due process.

Further, the intent requirement of the statute does not prevent arbitrary enforcement because the intent requirement does not apply to Jitesh's conduct. The "intent to cancel" requirement in the spoofing statute can prevent arbitrary enforcement when the statute is applied to traders, but Jitesh did not make the trades at issue in this case. In fact, Jitesh had never traded before. Trading is a complex and high-speed decision making process, and there is no way Jitesh could anticipate Sarao's future intent when Sarao manually placed the specific trades alleged in the indictment more than a year after the program was written. Even the Seventh Circuit implicitly recognized that non-traders could not form the intent required under the spoofing statute in *Coscia*. *Id.* at 794 ("prosecution is thus limited to the pool of *traders* who exhibit the requisite criminal intent") (emphasis added). Thus, the intent requirement in the spoofing statute does not prevent arbitrary enforcement when applied to Jitesh's conduct.

There is also clear evidence that the government is in fact engaging in arbitrary and subjective enforcement of the spoofing statute, given the disparate treatment of Jitesh, the owner of a software company, and programmers who personally created products that were used to spoof. For example, Jeremiah Park, the programmer who personally created Coscia's trading programs, wrote programs for Coscia that allowed Coscia's orders to be *pre-programmed* to automatically cancel after a certain period of time or when Coscia's small order on the other side of the market was filled (among other triggers). *Id.* at 789. Mr. Park testified at trial that Coscia specifically "asked that the programs act '[l]ike a decoy,' which would be '[u]sed to pump [the] market.'" *Id.* The government did not charge Mr. Park with any spoofing-related charges even though he was aware of Coscia's intent to spoof and his conduct was clearly within the applicable statute of limitations.

Nor did the government bring charges against the programmer Sarao first worked with to implement his trading program who Sarao actually *told* he wanted to place undetected spoof orders and move the market. Sarao Indictment, ¶¶ 11, 12, 14 (*e.g.*, Sarao told this programmer that under certain circumstances, he would want to "spoof it [*i.e.*, the market] down[,]" that if he kept "entering the same clip sizes, people will become aware of what I am doing, rendering my spoofing pointless[,]" and that he wanted "to make it [the program] workable in terms of me moving the market like we discussed"). The government also did not charge either of the other two programmers Sarao allegedly worked with after Programmer 1, even though Sarao asked their company to create a program with a "cancel if close" function that would cause his "order [to] be pulled if there are not x amount of orders beneath it" and that he wanted to be able "to enter multiple orders at different prices using one click." *Id.* at ¶ 18.

Taken together, the government's selective prosecution of Jitesh, the fact that Jitesh's conduct is far outside the core of the spoofing statute's prohibited conduct, and Jitesh's inability to have the intent that the Seventh Circuit found prevents arbitrary enforcement of the spoofing statute show that applying the spoofing statute to Jitesh's conduct constitutes unconstitutional arbitrary enforcement, and the charges must be dismissed.

B. Applying Spoofing-Related Charges to Jitesh's Conduct is Void for Failing to Provide Fair Notice

In addition to being void due to the statute's arbitrary enforcement as applied to Jitesh, Jitesh also lacked fair notice that the spoofing statute prohibited the owner of a software company from creating software that a trader used to spoof. No one, including the Seventh Circuit, anticipated that the government would use the anti-spoofing statute to charge owners of companies that developed software. The statute was written to prohibit trading activity, not running a software company. Jitesh thus lacked fair notice of what could constitute aiding or abetting or conspiracy to commit the conduct prohibited by the statute.

This lack of fair notice is magnified by how recently the statute was enacted. The Dodd-Frank Act amended the CEA to add the provision prohibiting spoofing in 2010, just a year before Sarao contacted Edge Financial for assistance in creating the program he devised. At the same time Edge Financial was working with Sarao to develop a program according to Sarao's specifications, both the CFTC and financial industry at large were struggling to define, provide guidance on, and better understand the precise conduct that the new spoofing provision prohibited. *See* Background, *supra*.

It was not until more than a year after Edge Financial completed the program for Sarao in January 2012 that Sarao allegedly used to place spoof orders that the CFTC was able to finally issue a final Interpretive Order in May 2013 that provided guidance on what conduct the new spoofing provision prohibited after numerous roundtable discussions, conversations, and correspondence with industry leaders; a request for public comments on the conduct this statute prohibited; and an initial proposed interpretive order on what conduct the provision prohibited. *Id.*

To determine if a statute meets constitutional notice requirements, a court must analyze whether a person of "common intelligence" would be on notice of what conduct constitutes a crime under the new spoofing provision. *Bence v. Breier*, 501 F.2d 1185, 1188 (7th Cir. 1974) (quoting *Connally v. General Construction Co.*, 269 U.S. 385, 391 (1926)). In this case, where regulators and trading industry leaders were struggling to understand and define what conduct the new statute prohibited, it is unimaginable to assume the owner of a software company, who had never traded before and had no knowledge of the complexities that go into placing bids and offers, could at that time have fair notice that allowing his company to create a software program with certain functions requested by a trader could subject him to criminal liability for spoof trades made by the trader years later. Further, the interpretive guidance the CFTC finally put out about the spoofing provision in May 2013 specifically found that a person would need to evaluate market context, a person's pattern of trading activity (including fill characteristics), and other relevant facts and circumstances to distinguish between legitimate trades and spoofing. *See* 78 Fed. Reg. 31,890-01. When Edge Financial delivered the program to Sarao in January 2012, it was impossible for Jitesh to know the market contexts, Sarao's pattern of trading activity and other relevant facts and circumstances for Sarao's trades that would not occur until years later.

The government's novel application of the spoofing statute in this case, which was not clearly defined when Jitesh engaged in the alleged unlawful conduct, violates the fundamental tenants of due process, and the charges based on this conduct must be dismissed.

II. THE STATUTE OF LIMITATIONS BARS THE AIDING AND ABETTING COUNTS OF THE INDICTMENT

In addition to stretching the bounds of due process to bring these unprecedented and unfounded charges against Jitesh, the government also went outside of the statute of limitations to charge Jitesh with aiding and abetting spoofing (Counts II and III). Those counts of the indictment must be dismissed as untimely. The applicable statute of limitations for the offense of aiding and abetting is the statute of limitations for the substantive offense charged. *See S.E.C. v. Buntrock*, No. 02 C 2180, 2004 WL 1179423, at *8 (N.D. Ill. May 25, 2004), *aff'd sub nom. S.E.C. v. Koenig*, 557 F.3d 736 (7th Cir. 2009). Jitesh was charged with aiding and abetting spoofing, which is subject to a five-year statute of limitations. *See* 18 U.S.C. § 3282. The indictment does not allege any conduct by Jitesh within the five-year statute of limitations to aid and abet the instances of alleged spoofing in Counts II and III of the indictment because there was no such conduct, and these counts must be dismissed.

On January 19, 2018, Jitesh was charged with two counts of aiding and abetting Sarao's spoofing. Thus, the five-year statute of limitations encompasses conduct occurring on or after January 19, 2013. Counts II and III of the indictment allege that Jitesh aided and abetted the following spoof orders Sarao allegedly placed:

Count	Approx. Date Order Placed	Approx. Time Order Placed	Side
2	Feb. 25, 2013	13:37:54.313	Sell
3	Mar. 8, 2013	9:52:23.983	Sell

Indictment ¶ 37.

Based on the dates of the alleged spoof orders Sarao placed, the only action Jitesh could have taken to aid and abet these trades within the limitations period would have had to occur in the 38 days between January 19, 2013 and February 25, 2013. Unsurprisingly, the indictment does not contain a single specific allegation about Jitesh's conduct between January 19, 2013 and February 25, 2013, much less an allegation that Jitesh took some action to aid or abet these two spoof orders during the relevant timeframe. In fact, the last allegation in the indictment relating to Jitesh's conduct prior to Sarao's first alleged spoof order on February 25, 2013 is an allegation of an email exchange between Sarao and Jitesh on January 30, 2012 in which Sarao allegedly sent comments and requests to clarify his requirements. *Id.* at ¶ 26. The statute of limitations for this last email exchange expired nearly a year before the government charged Jitesh in 2018.

The allegations in the indictment make clear that after Sarao first contacted Edge Financial in or around October 2011, Edge Financial worked with Sarao to deliver a program based on Sarao's specifications in January 2012 (one year beyond the statute of limitations) and did not have further contact with Sarao until nearly two years later, when Sarao and Jitesh communicated briefly regarding payments in December 2014, more than a year and a half *after* the trades Jitesh is alleged to have aided and abetted. *Id.* at 30. Thus, the government's prosecution of Jitesh for aiding and abetting is untimely, and Counts II and III should be dismissed.

III. STATEMENTS BY PROSECUTORS OR WITNESSES TO THE GRAND JURY REGARDING THE PREJUDICIAL AND INFLAMMATORY LANGUAGE IN THE INDICTMENT MUST BE REVIEWED AND THIS PREJUDICIAL AND INFLAMMATORY SURPLUSAGE SHOULD BE STRICKEN FROM THE INDICTMENT

In order to make the actions of a software company owner who did not engage in any trading appear more egregious to the jury, the government included an irrelevant and prejudicial "example" of market manipulation in the indictment—a crime that Jitesh was not charged with. In the event this Court does not dismiss all counts of the indictment for the reasons above, Jitesh moves, in the alternative, for: (1) the Court to perform an *in camera* review of the grand jury proceedings related to this "example" to see if it was used to mislead or prejudice the grand jury; and (2) for the Court to strike this prejudicial and inflammatory language from the indictment.

Paragraph 10 of the indictment defines spoofing and then goes on to describe market manipulation as "one of the many ways spoofing could be used." Indictment ¶ 10. Paragraph 10(a)-10(f) gives a detailed explanation of how a trader could use spoof orders to manipulate market prices. But market manipulation is a separate and distinct crime under the CEA. *See* 7 U.S.C. § 13(a)(2). The government did *not* charge Jitesh with market manipulation or allege that Jitesh conspired to engage in market manipulation or aided and abetted market manipulation.

This is important because market manipulation requires the government to prove that the defendant had the ability to influence market prices, that artificial prices existed, and that the defendant caused the artificial prices. *In re Dairy Farmers of America, Inc. Cheese Antitrust Litigation*, 801 F.3d 758, 764-65 (7th Cir. 2015). Due to this high burden, the government has never obtained a criminal conviction for market manipulation. In contrast, spoofing requires no proof that the defendant influenced prices at all. The only purpose the government's inclusion of this irrelevant example in the indictment serves is to inflame and confuse the jury into believing that Jitesh conspired with or aided and abetted Sarao to manipulate the commodities market, a crime that Jitesh has not been charged with. The government's use of the irrelevant market manipulation example as "one of the many ways spoofing could be used" is as preposterous as giving an example of conspiracy to commit a murder as "one of the many ways conspiracy could be used" in an indictment that charges a defendant with conspiracy to commit a different or lesser crime. This "example" of a crime Jitesh has not been charged with in Paragraph 10 is not relevant to the elements of the crimes the government *has* charged Jitesh with.

A. An *In Camera* Review of Grand Jury Testimony Related to this "Example" is Necessary

Given that the government included this irrelevant and prejudicial "example" of market manipulation in the indictment, it's conceivable that the government used this same "example" to prejudice or mislead the grand jury in this case. Jitesh requests that the Court perform an *in camera* review of the transcript of the grand jury proceedings in this case to determine if the prosecution used this "example" improperly at those proceedings in a way that would support a motion to dismiss the indictment. A court may authorize disclosure of a grand-jury matter "at the request of a defendant who shows that a ground may exist to dismiss the indictment because of a matter that occurred before the grand jury." Fed. R. Crim. P. 6(e)(3)(E)(ii). During grand jury proceedings, a prosecutor may not "mislead [the grand jury] or engage in fundamentally unfair tactics before it." *United States v. Ciambrone*, 601 F.2d 616, 623 (2d Cir. 1979).

"Knowing or reckless misleading of the grand jury as to an essential fact" is grounds for dismissal of an indictment that allows disclosure of grand jury testimony. *See United States v. Buck*, No. 84 CR. 220-CSH, 1986 WL 12726, at *1 (S.D.N.Y. Oct. 31, 1986).

A review of the grand jury proceedings is necessary to determine if the government presented evidence about the crime of market manipulation to the grand jury, or suggested that this case was about market manipulation, even though Jitesh was not charged with that crime. If the government made inflammatory statements about "market manipulation" to the grand jury, it may have misled or prejudiced the grand jury into believing Jitesh aided or conspired to engage in market manipulation. These inflammatory statements may have caused the grand jury to approve the charges against Jitesh on an improper basis. As discussed above, market manipulation is a completely separate crime that Jitesh was not charged with and that requires the government to meet a high burden to prove. Because it appears that the government may have presented evidence about the crime of market manipulation to the grand jury or made statements to the grand jury suggesting that Jitesh and Sarao conspired to engage in market manipulation, a review of the grand jury testimony is necessary to ensure that the government disclosed the high burden they would have to meet to prove market manipulation had it actually charged Jitesh with this crime. For that reason, Jitesh requests that this Court review the grand jury transcript to determine whether the government used the concept of market manipulation to knowingly or recklessly mislead the grand jury into believing that their evidence proves a conspiracy to manipulate the market without instructing the jury as to the elements of market manipulation, warranting dismissal of the indictment.

The narrow relief requested here is appropriate. If the Court determines through its *in camera* review that the prosecution did not mislead or potentially prejudice the grand jury with this "example," the Court does not need to disclose the grand jury proceedings to Jitesh. However, if the Court finds that the prosecution discussed "market manipulation" with the grand jury in a manner that could have suggested to the grand jury that Jitesh aided or conspired to manipulate market prices, the Court should disclose the grand jury proceedings to Jitesh because there may be grounds to dismiss the indictment in its entirety on this basis.

B. This "Example" Must be Stricken from the Indictment

Regardless of whether the Court undertakes an *in camera* review of the grand jury proceedings, the irrelevant and prejudicial "example" of market manipulation must be stricken from the indictment. Rule 7(d) of the Federal Rules of Criminal Procedure allows a court to "strike surplusage from the indictment" upon defendant's motion. Fed. R. Crim. P. 7(d). A motion to strike should be granted when "the targeted allegations are clearly not relevant to the charge and are inflammatory and prejudicial." *United States v. Groos*, 616 F. Supp. 2d 777, 789 (N.D. Ill. 2008) (quoting *U.S. v. Black*, 469 F. Supp. 2d 513, 518 (N.D. Ill. 2006)) (granting defendant's motion to strike under Rule 7(d)). "The purpose of (rule 7(d)) is to protect the defendant against prejudicial allegations of irrelevant or immaterial facts" because "[p]rosecutors have been known to insert unnecessary allegations for 'color' or 'background' hoping that these will stimulate the interest of the jurors." *United States v. Brighton Bldg. & Maint. Co.*, 435 F. Supp. 222, 230 (N.D. Ill. 1977). Further, allegations in an indictment that "may lead the jury to infer allegations of crimes beyond those actually charged" are improper and should be stricken from the indictment. *United States v. Beverly*, No. 87 CR 521, 1988 WL 48291, at *3 (N.D. Ill. May 11, 1988); *see also Brighton Bldg. & Maint. Co.*, 435 F. Supp. at 230 (striking language from the indictment that "serves no useful purpose and allows the jury to draw the inference that the defendant is accused of crimes not charged in the indictment").

As discussed above, the allegations in the indictment related to the crime of "market manipulation" are just such irrelevant and prejudicial surplusage that could cause the jury to infer allegations of crimes beyond those Jitesh is actually charged with and must be stricken. This "example" of a crime Jitesh has not been charged with in Paragraph 10 is not relevant to the elements of the crimes the government *has* charged Jitesh with. *Groos*, 616 F. Supp. 2d at 790. Thus, if this Court does not dismiss the entirety of the indictment, the Court should strike all of paragraph 10 of the indictment except the first sentence, including subsections (a) through (f).

CONCLUSION

For the foregoing reasons, this Court should grant Mr. Thakkar's motion, dismiss the indictment with prejudice, and grant such other or further relief as this Court deems proper.

Respectfully submitted,
THOMPSON COBURN, LLP

By: */s/ Renato Mariotti*

Renato Mariotti
Holly H. Campbell
THOMPSON COBURN LLP
55 East Monroe St., 37th Floor
Chicago, Illinois 60603
(312) 346-7500
rmariotti@thompsoncoburn.com
hcampbell@thompsoncoburn.com

Attorneys for Jitesh Thakkar

CERTIFICATE OF SERVICE

The undersigned hereby certifies that he electronically filed the foregoing **Memorandum of law in support of Jitesh Thakkar's Motion to Dismiss the Indictment with Prejudice, or in the Alternative, For *In Camera* Review of the Grand Jury Transcript and to Strike Prejudicial Language from the Indictment** with the Clerk of the Court on May 29, 2018, using the CM/ECF system, which sent notification of such filing to all counsel of record in this matter.

/s/ Renato Mariotti

EXHIBIT A

Futures Industry Association
2001 Pennsylvania Ave. NW
Suite 600
Washington, DC 20006-1823
202.466.5460
202.296.3184 fax
www.futuresindustry.org

FIA

December 23, 2010

Commodity Futures Trading Commission
c/o David A. Stawick, Secretary
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: **Antidisruptive Practices Authority Contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act. RIN No. 3038-AD26.**

Dear Mr. Stawick:

The Futures Industry Association ("FIA")[1] submits these comments in response to the Commodity Futures Trading Commission's (the "Commission") Advance Notice of Proposed Rulemaking and Request for Comments ("ANPR") on Antidisruptive Practices Authority Contained in Section 747 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). FIA appreciates the opportunity to comment on Section 747 and the Commission's ANPR questions. FIA and its members share the Commission's commitment to open, fair and competitive markets.

However, in Section 747 of Dodd-Frank, Congress has passed an overly vague provision that is not clearly defined and prohibits activities that are also not subject to clear definition. While we are mindful of the adverse impacts of disorderly markets, we are at the same time concerned that there are no clear standards under Section 747. The terms "disruption" or "disruptive" are not sufficiently descriptive to have operational meaning, nor have they been defined.

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1 FIA is a principal spokesman for the commodity futures and options industry. FIA's regular membership is comprised of approximately 30 of the largest futures commission merchants ("FCMs") in the United States. Among its associate members are representatives from virtually all other segments of the futures industry, both national and international. Reflecting the scope and diversity of its membership, FIA estimates that its members effect more than eighty percent of all customer transactions executed on United States designated contract markets.

I. Summary.

FIA recommends the following to the Commission:

- The Commission should clearly identify the specific characteristics, problems or concerns which would be subject to the additional enforcement authority in connection with disruptive trading practices, and should fashion any rules to specifically address those identified characteristics, problems and concerns.[2] The Commission should take into account the vagueness of Section 747's amendments to the Commodity Exchange Act ("CEA") and the lack of any definition of other identified "trading practice that is disruptive of fair and equitable trading."[3]

- The statute is impermissibly vague and unenforceable. Definitions such as "orderly execution," "violates bids or offers" and "spoofing" require refinement and clarification by the Commission so that their meanings relate to specific and measureable characteristics that can guide market participants in their conduct. These definitions should take into account the distinct structures, practices and assumptions of the futures and derivatives markets. The Commission should also clarify that manipulative intent is required to breach these prohibitions.

- The rulemaking must reinforce the distinct and complementary roles of the Commission and of the exchanges. Under "core principle" number four in Section 5 of the CEA, as amended by Dodd-Frank, the exchanges have duties to oversee trading activities, and the Commission should be assured that the exchanges have the requisite tools and procedures to address and prevent disruptive trading practices.[4] The exchanges should establish policies and procedures for market users and executing and clearing brokers to address possible market disruption concerns.

- Executing brokers must be given a safe harbor from customer liability if they choose not to execute a customer trade after having implemented policies and procedures reasonably designed to prevent market disruptions. Consistent with the above, market users should also receive similar protections if they adopt policies and procedures reasonably designed to prevent market disruptions. The Commission should not impose liability on executing brokers who unintentionally cause market disruptions while executing a customer trade as long as the proper policies and procedures reasonably designed to prevent market disruptions were in place.

- The Commission must clarify that CEA Section 4c(a)(7) (entitled "Use of Swaps to Defraud") will only be violated if a party violates a pre-existing duty arising

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2 *See* Section II, *infra*.

3 CEA § 4c(a)(6).

4 7 U.S.C. § 7(d)(4).

under contract, by operation of common law or under some other non-CEA source.

- Commission Regulation 166.3 already applies to supervision relating to disruptive trading practices and should be sufficiently effective without enumerating additional specific duties.

- The Commission should carefully consider the potential of any proposed rule to stifle liquidity and financial innovation.

II. The Commission Should Clearly Identify the Problems or Concerns Which Necessitate Additional Enforcement Authority.

The Commission has not identified specific problems or concerns where its pre-Dodd-Frank enforcement authority was lacking. Because the language of Section 747 came from the Commission itself, it is incumbent upon the Commission to identify past or ongoing problems that Section 747 is targeted to address.[5] Absent identification of such problems, FIA urges the Commission to seek repeal of this provision. Section 747's language is vague and potentially broad enough to capture many legitimate trading activities. The language has the very real potential to harm market quality by chilling market participation, stifling liquidity and increasing spreads. As such, to the extent the provision is not repealed, the Commission should clarify how it intends to use this authority in a manner that is both focused and clearly understood by all market participants. Any potential rulemaking that falls short of this will cause unintended consequences, including a detrimental impact on price discovery and quality of the futures and derivatives markets.

III. Section 747 Is Impermissibly Vague and Unenforceable.

Section 747, as written, is extremely vague and vulnerable to constitutional challenge by market participants. Due process precludes the Commission from penalizing a private party for violating a rule without first providing adequate notice of the substance of the rule.[6] Market participants have expressed legitimate concerns of unpredictable and fundamentally unfair enforcement actions. The breadth of the statute has the potential to capture many legitimate trading activities, and therefore to chill permissible market participation.

Definitions such as "orderly execution," "violates bids or offers" and "spoofing" in Sections 4c(a)(5)(A), (B) and (C), respectively, require refinement and clarification by the Commission so that their meanings relate to specific and measurable characteristics that can guide market participants in their conduct. The Commission should clarify that manipulative

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5 In a floor statement, Senator Blanche Lincoln stated that the "[Commission] requested, and received, enforcement authority with respect to . . . disruptive trading practices," but failed to elaborate on the new authority's meaning. 107 Cong. Rec. S5922 (2010).

6 *Satellite Broad. Co.* v. *FCC*, 824 F.2d 1, 3 (D.C. Cir. 1987); *see also DiPlacido* v. *CFTC*, No. 08-5559-ag, 2009 WL 3326624, at *1 (2d Cir. Oct. 16, 2009); *In re Collins*, [1986-87 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶23,401 (Nov. 26, 1986).

intent is required to breach these prohibitions. Additionally, the Commission's clarifications must be done in a manner that takes into account the distinct structures, practices and customs of the futures and derivatives market.

A. "Violates Bids or Offers" in 5(A) Is Unclear in the Futures and Derivatives Markets.

Violating bids or offers does not have a clear meaning in the futures and derivatives markets. The ANPR requests comments on how the term is to be applied "in the context of electronic trading platforms with pre-determined order-matching algorithms that preclude a trader from executing an order against a quote other than the best one available." Matching engines make it impossible to sell or buy except at the best available quote. Simply stated, the statute is not appropriate in the electronic markets.

Furthermore, the Commission should clarify that the prohibition on violating bids or offers does not apply in the over-the-counter markets. Traders with large positions may seek to privately negotiate a trade with a counterparty, and the negotiated price may very well be outside the range of current bids or offers. Credit, size of the trade or other factors may cause the parties to negotiate terms outside the bid or offer. Executing outside the bid-offer spread should not be a violation without manipulative or disruptive intent. Markets that are thinly traded may not have clear parameters on bids or offers but may depend on a multitude of other factors when discovering price. Simply focusing on a violation of a bid or offer is placing too narrow a focus in defining a disruptive practice and offers little guidance to market participants. The Commission must therefore clarify that legitimate trading practices such as these, which have no manipulative intent, are not captured by Section 4c(a)(5)(A).

The Commission should clarify that manipulative intent to create an artificial price is required to violate 5(A)'s prohibition on violating bids or offers. Most striking about the violating bids or offers prohibition is its lack of any required mental state. While 5(B)'s prohibition on the intentional or reckless disregard for orderly execution and 5(C)'s prohibition on "spoofing" both reference some level of intent, 5(A)'s prohibition does not establish the requisite level of intent. The Supreme Court has pointed to the lack of a *mens rea* requirement in a vague statute as a sign of unconstitutionality:

> [T]he constitutionality of a vague statutory standard is closely related to whether that standard incorporates a requirement of *mens rea*. Because of the absence of a scienter requirement in the provision [in question], the statute is little more than 'a trap for those who act in good faith.'[7]

The disruptive practice definition in 5(A) is both vague and lacking in any *mens rea*. To remedy this, the Commission must follow judicial precedent and its own past enforcement practices and clarify that violations of bids or offers are prohibited only if undertaken with specific

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7 *Colautti* v. *Franklin*, 439 U.S. 379, 395 (1979) (citations omitted); *see also DiPlacido*, 2009 WL 3326624 at *2 (citing *Colautti*).

manipulative intent. In *DiPlacido*, the Second Circuit upheld the Commission's enforcement action only because the Commission required manipulative intent:

> DiPlacido further challenges the Commission's standard on the ground that the elements of the four-part test 'collapse[]' into one-uneconomic-trading-so [sic] that a violation exists wherever bids and offers are violated, and even lawful hedging may constitute manipulation. We are not persuaded. The Commission stated that 'violating bids and offers—*in order to influence prices*' was 'sufficient to show manipulative intent.' Its finding of intent thus depended not merely on DiPlacido's having violated bids and offers, but also on taped conversations signaling manipulative intent . . .[8]

Without clarifying the types of bids or offers that are prohibited disruptive practices and requiring manipulative intent, the statute is vulnerable to constitutional challenge and will not serve the purposes of Congress or the Commission. FIA urges the Commission to clarify these issues.

B. "Orderly Execution of Transactions During the Closing Period" Is Impermissibly Vague and Will Chill Many Legitimate Trading Practices.

The proposal does not offer any explanation as to what "orderly execution" in 5(B) actually means, nor is there a commonly understood meaning among futures and derivatives market participants. The Commission should clarify that traditionally accepted types of market manipulation, such as "banging the close," "marking the close" and pricing window manipulation fall under the prohibition of 5(B). Beyond these, the Commission must identify the other practices, if any, that will be deemed to constitute an "intentional or reckless disregard for the orderly execution of transactions during the closing period." It is incumbent on the Commission to do so in order to provide adequate notice to market participants.

The Commission should clarify that manipulative intent is necessary under 5(B)'s prohibition. The Commission should not engage in *post hoc* judgments of disruptive practices without a finding of manipulative intent. Any particular trade has the potential to be disruptive given unpredictable market conditions. Indeed, trades that are not in and of themselves disruptive may end up causing a disruption for reasons no single market participant can reasonably foresee, as the May 6 "flash crash" demonstrated. Market participants that create isolated disruptions through *bona fide* trading activities should not be sanctioned absent manipulative intent. Should the Commission decline to require a showing of manipulative intent, many market participants will decide that the regulatory risk of engaging in legitimate trading in thin, volatile or unpredictable markets is simply too great and will pull out of those markets. This will only create or exacerbate illiquidity and volatility in the markets, to the detriment of all market participants.

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8 *DiPlacido*, 2009 WL 3326624 at *3 (2d Cir. Oct. 16, 2009) (citations omitted; emphasis original).

C. The Commission Must Define and Clarify What Entails "Spoofing" in the Context of the Futures and Derivatives Markets.

The term "spoofing" is not one that has been commonly used in the futures and derivatives markets and there is no generally understood or accepted meaning of the term in this context, or of the conduct that would be prohibited by reference to this term. In the securities markets, the Securities and Exchange Commission (the "SEC") has initiated enforcement actions on alleged "spoofing" practices. Spoofing in the securities markets is a form of price manipulation of the national best bid or offer ("NBBO") through the use of limit orders in order to increase profits on subsequent market orders. The SEC's Limit Order Display Rule requires that market makers display customer limit orders of 100 shares or more, and if the customer limit order is better than the previously displayed NBBO it will change the NBBO by either raising the bid side or lowering the offer side. Once the trader executes a market trade at the artificial NBBO price, he or she subsequently cancels the original limit order.[9] Thus, the practice entails "bidding or offering with the intent to cancel the bid or offer before execution."[10] The Commission should not simply import this definition into its rules, for two reasons. First, these interpretations and enforcement proceedings have not proceeded past the settlement phase at administrative levels, and thus they have not been the subject of judicial scrutiny. Second, it is unclear how the practice can be defined adequately given the substantial differences between the securities markets and the futures and derivatives markets.

Moreover, executing similar trade practices in the futures and derivatives markets does not carry with it a reliable indication of manipulative intent. The placing of large orders consistent with market practice and for *bona fide* business reasons, with no intent to affect prices, is a legitimate commercial practice that provides an important source of liquidity. A trader may put in a much larger order than is anticipated to be filled in order to ensure its needs are met.[11] Because of the probabilistic nature of the futures and derivatives settlement process, traders must engage in practices that might fall under the cloud of the "spoofing" prohibition. Spoofing is also difficult to distinguish from market makers' order and cancel activity or active trading orders when they are "chasing a market" that is linked to other active markets. As such, any disruptive practice defined as "spoofing" must require a manipulative intent to influence price in order to impose some boundaries on the vague statutory prohibition.

As a general matter, the adoption of regulations based on the foregoing principles would recognize that there are many "ordinary course of business" situations in which a market participant places an order with the intention and expectation that it will be filled and, as the result of subsequent market conditions or other external factors, withdraws all or a portion of the

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9 *See, e.g., In re Fishman*, Exchange Act Release No. 40115 (June 24, 1998); *In re Monski*, Exchange Act Release No. 44250 (May 3, 2001); *In re Shenker*, Exchange Act Release No. 45017 (Nov. 5, 2001); *In re Blackwell*, Exchange Act Release No. 45018 (Nov. 5, 2001); *In re Frazee*, Exchange Act Release No. 47522 (Mar. 18, 2003).

10 CEA § 4c(a)(5)(C).

11 *See* Antidisruptive Practices Authority Contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act, 75 Fed. Reg. 67,301, 67,302 (Nov. 2, 2010) (question eight).

order before it is filled. The ability for market participants to fine-tune their risk and exposure in this manner improves market quality with tighter spreads and deeper liquidity. Limitations on this ability would adversely affect market quality.

Finally, when it comes to prohibiting "any other trading practice that is disruptive of fair and equitable trading," the Commission should define what other practices might fall under this generic term.[12] Because the preceding list of disruptive practices does not lend itself to a limited or plausibly bounded set of potential practices, statutory interpretation tools such as *noscitur a sociis* are simply of no utility.[13] This term provides no guidance whatsoever to market participants. Consequently, FIA believes that it is necessary to elaborate on this clause given the Commission's ample authority in Sections 5(A)-(C) and other provisions of its statute, including CEA Sections 4b, 6(c)(1), 6(c)(3) and 9(a)(2).

Given the difficulties outlined above, the Commission should recommend to Congress that this provision be repealed.

IV. Section 747 Rulemaking Must Reinforce the Distinct and Complementary Roles of the Commission and of the Exchanges.

The Commission should issue principles-based guidance that reinforces the traditional approach to regulating disruptive practices. Historically, there have been distinct and complementary roles of the Commission in its exercise of its anti-manipulation authority and the exchanges' own mechanisms for maintaining market discipline. The Commission has long embraced principles-based regulation to reinforce this structure, and the role of the self-regulatory organization ("SRO") to leverage supervision in the markets.

The CEA recognizes the important role that exchanges play in preventing market disruptions. The CEA mandates that boards of trade comply with certain "core principles" but gives them flexibility by affording them reasonable discretion in the manner in which they comply.[14] Core principle number four, as amended by Dodd-Frank, mandates that the boards of trade "have the capacity and responsibility to prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process."[15] Similarly, Dodd-Frank imposes the same mandate of preventing manipulation, price distortion and disruptions on Swap Execution Facilities ("SEFs").[16] FIA urges that this important role of exchanges be reaffirmed through principles-based guidelines that afford exchanges reasonable discretion.

12 7 U.S.C. § 6c(a)(6).

13 *Noscitur a sociis* holds that a word is known by the company it keeps. *See Babbitt* v. *Sweet Home Chapter of Communities for a Great Oregon*, 515 U.S. 687, 693 (1995).

14 7 U.S.C. § 7(d).

15 7 U.S.C. § 7(d)(4).

16 Dodd-Frank § 733.

Engaging the exchanges to police the markets is also consistent with Dodd-Frank. Specifically, Dodd-Frank Section 735 changes core principle number four by enhancing the role of the exchanges. Instead of merely being required to *monitor* trading, a board of trade will now be required to "have the *capacity and responsibility*" to prevent manipulation, price distortion and disruptions through market surveillance, compliance and enforcement practices and procedures.[17] Dodd-Frank specifies that appropriate policies and procedures include "methods for conducting real-time monitoring of trading" and "comprehensive and accurate trade reconstructions."[18] These policies and procedures, already implemented at many of the leading exchanges, have proven effective at mitigating market disruptions. Most recently, Chicago Mercantile Exchange ("CME") Stop Logic Functionality played a pivotal role during the May 6, 2010 "flash crash." The Commission and the SEC recognized its effectiveness as a lesson learned:

> As demonstrated by the CME's Stop Logic Functionality that triggered a halt in E-Mini trading, pausing a market can be an effective way of providing time for market participants to reassess their strategies, for algorithms to reset their parameters, and for an orderly market to be re-established.[19]

To upend this traditional structure by creating vague obligations at the Commission enforcement level and to preempt the roles of the exchanges is unnecessary and unwarranted. Exchanges must be given the flexibility to adapt in constantly changing markets in order to address new dangers of market disruption. A prescriptive rules-based approach would weigh down the exchanges' efforts and create greater uncertainty among market participants.

FIA believes that these distinct roles have served the market well. However, to the extent the Commission is able to identify a supervisory gap between the Commission's enforcement authority with respect to anti-manipulation, and the exchanges' role of preventing disruptions, the Commission should clarify the authority and responsibilities of the exchanges, in keeping with the exchanges' historic role. In doing so, the Commission would be able to leverage the vast resources of the exchanges to increase oversight, subject to the general supervision of the Commission. By confining itself to monitoring and deterring market manipulation, the Commission can focus its resources and capitalize on its enforcement expertise. Limiting itself to manipulation investigations is also appropriate because market disruptions are not used by market participants to gain illicit profits through unfair advantages. Federal enforcement and sanctions are inappropriate tools because, unlike manipulative conduct, market participants do not gain from market disruptions.

V. Section 4c(a)(7) Must Be Clarified and Made Consistent with Other Commission Guidance.

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17 Dodd-Frank § 735(b).

18 *Id.*

19 CFTC and SEC Joint Advisory Committee on Emerging Regulatory Issues, *Findings Regarding the Market Events of May 6, 2010*, at 6 (2010).

FIA urges the Commission to clarify that Section 747 does not impose any new duties of disclosure, inquiry or diligence. Section 747 of Dodd-Frank makes it "unlawful for any person to enter into a swap knowing, or acting in reckless disregard of the fact, that its counterparty will use the swap as part of a device, scheme or artifice to defraud any third party" under the new Section 4c(a)(7) of the CEA. Futures and derivatives markets participants have not traditionally been subject to these types of duties. Without this clarification, market participants will face increased compliance and operational costs, as well as greater uncertainty, in connection with their legitimate trading activities.

FIA believes that Section 4c(a)(7) should only be deemed to have been violated if a party breaches a pre-existing duty arising under contract, by operation of common law or under some other non-CEA source. FIA supports the application to Section 747 of the Commission's clarification in its proposed rules on market manipulation that:

> Nothing in [the proposed rule] shall be construed to require any person to disclose to another person nonpublic information that may be material to the market price, rate, or level of the commodity transaction, except as necessary to make any statement made to the other person in or in connection with the transaction not misleading in any material respect.[20]

FIA urges caution in interpreting and applying this new provision, given its potential to alter long-standing and legitimate trading practices.

VI. Executing Brokers Are Not in a Position to Adequately Supervise.

The Commission has asked whether executing brokers should have an obligation to ensure that customer trades are not disruptive practices. FIA urges that the Commission be guided by a policies and procedures approach in this area, as it allows for adequate enforcement and recognizes the practical difficulties brokers face. The exchanges and the Commission may take weeks, if not months, to identify a disruptive trade practice or manipulation. It would be unreasonable for the Commission to require executing brokers to make similar determinations, pre-trade. Executing brokers are not equipped to discern intent, given that they are not in a position to see a pattern or practice which might lead to an inference of manipulative intent. The responsibilities of executing brokers, particularly in electronic trading environments, should be carefully prescribed, since there is even less of an opportunity to evaluate a trade besides implementing pre-trade checks in the software itself.

Executing brokers should be deemed to have satisfied their responsibilities if they design appropriate structural safeguards to ensure that that their clients have appropriate checks against entering orders likely to lead to market disruptions. These safeguards should recognize the rapid changes in electronic markets and should be applied at the exchange level in accordance with principles-based regulation. The CME Group currently has in place risk management Rule 982 which requires clearing members to have written risk management

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[20] Prohibition of Market Manipulation, 75 Fed. Reg. 67657, 67662 (2010).

policies and procedures in place to ensure that they are able to perform certain basic risk and operation functions at all times. Similar requirements should apply to executing brokers who accept orders. They should adopt and enforce written procedures and controls reasonably designed to screen, and prevent customers from engaging in, trades that create undue risks of market disruptions.

FIA's Market Access Working Group ("MAWG"), comprised of representatives from clearing firms, proprietary trading firms and exchanges, has developed recommendations for executing brokers on managing the risks of direct access while striking an appropriate balance between guiding principles and prescriptive mandates.[21] Pre-trade diligence procedures and controls should include:

- access to a "kill button" to disable trading and cancel all resting orders;
- pre-trade and post-trade risk and position limits and controls;
- fat-finger quantity limits; and
- repeated automated execution throttles.

Given the spectrum of clients, executing brokers should be allowed to tailor pre-trade controls to the specific client based on a diligence review on the customer's trading practices, past dealings, sophistication and internal trade systems and controls in place. Prescriptive rulemaking simply does not allow for this kind of flexibility. The Commission must therefore allow for a principles-based approach and direct the exchanges to adopt appropriate standards.

Executing brokers that conform to these principles-based guidelines should be afforded safe harbor protection from customer liability when they choose not to execute a customer trade and from Commission enforcement actions when, despite good faith and the exercise of reasonable controls, a market disruption actually occurs. Because these decisions are made real-time and without the benefit of hindsight, executing brokers cannot be reasonably expected to eliminate all market disruption risk. At the same time, however, they face substantial liability if they choose not to execute a customer order based on a judgment that such execution would be disruptive. This places executing brokers in a difficult position of trying to meet customer needs, while being responsible in choosing to permit the execution of market trades.

FIA strongly believes that a multi-layered enforcement approach, which implements policies and procedures at the firm, exchange and clearing level, will most effectively mitigate the risk of market disruptions.

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21 FIA, *Market Access Risk Management Recommendations* (2010) (available online at http://www.futuresindustry.org/downloads/Market_Access-6.pdf). On May 6, 2010, FIA submitted the report in a comment letter to the SEC in connection Rule 15c3-5 (available online at http://www.futuresindustry.org/downloads/ SEC_Risk_Management_Controls_for_Brokers_or_Dealers_with_Market_Access_050610.pdf).

VII. The Commission Should Not Articulate Any Other Specific Duties of Supervision Relating to the Prohibited Trading Practices in Section 4c(a)(5) Since Regulation 166.3 Is Sufficiently Effective.

Question 14 of the ANPR asks whether the Commission should articulate specific duties of supervision to supplement the general duty to supervise contained in Commission Regulation 166.3. Regulation 166.3 already imposes a substantial, expansive and meaningful general supervisory duty on Commission registrants:

> Each Commission registrant . . . must diligently supervise the handling by its partners, officers, employees and agents . . . of all commodity interest accounts carried, operated, advised or introduced by the registrant and all other activities of its partners, officers, employees and agents (or persons occupying a similar status or performing a similar function) relating to its business as a Commission registrant.[22]

It is unnecessary to add any new duties of supervision in light of this requirement. The Commission should instead rely on Regulation 166.3.

VIII. Antidisruptive Practices Authority in the Context of Algorithmic and Automated Trading Systems.

The use of automated and algorithmic trading systems is widespread in the industry, from the professional to the retail trader. Trade automation is used by market makers to update their quotes. Professional traders use automation to limit risk and trade on short-term opportunities. Corporate and retail customers use automated trading systems to trade where client software and web-driven trading applications yield diverse market information.

Similarly, algorithmic systems are not new to the futures and derivatives markets. Program and system trading, as well as computerized contingent logic orders, have been an important part of these markets for decades. Both automated and algorithmic trading mechanisms are tools that market participants use to implement trading strategies, but are not trading strategies in themselves. Market participants who use these tools are already subject to supervision under conduct and marketplace rules.

Automation has played a critical role in the U.S. futures markets, improving the effectiveness of the market for all participants (short-term, long-term, institutional and retail investors, as well as commercial hedgers). These benefits include:

- Lower trading costs — The intense competition in these automated markets significantly contributes to narrower bid-ask spreads and consequently lowers trading costs for all participants.

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[22] 17 C.F.R. § 166.3.

- Fairer prices — Diverse automated trading strategies improve price discovery, ensuring prices track fair value and rapidly reflect all relevant market information.

- Resilient markets — Having a large, diverse, competitive set of automated traders ensures liquidity and efficient price discovery, even during market shocks.

- Increased liquidity — Automated trading activity provides substantial liquidity to all market participants, helping to bridge temporary gaps in supply and demand. This activity allows market participants to buy or sell with less impact on market price and dampens short-term market volatility.

Separate regulatory mandates regarding automated systems that are broadly or vaguely defined would create regulatory uncertainty and would have a negative impact on brokers' and market makers' ability to provide liquid markets. The impossibility of knowing how to avoid violating a vaguely defined prohibition in the course of ordinary market activity may deter many current market participants from trading. The deterrence of legitimate trading activity, in turn, may lead to wider spreads.

The markets have order entry and volatility controls in place to limit disruptive trading without deterring legitimate trading activity. Broadly construed, disruptions occur on a daily basis in every market, but exchanges already have a variety of mechanisms to address disruptive trading. For example, rules on price banding, limit up/limit down, and stop logic, along with continuous monitoring, are all effective tools to prevent disruptions.

Even in the context of "buying the board" or buying all the liquidity, unless there is intent to manipulate price, this should not be defined as a disruptive trading practice subject to Commission enforcement. For example, CME Stop Logic Functionality protects against cascading stop orders—the domino effect of one stop order triggering others—from precipitating a material market decline because of a transitory dearth of liquidity by giving a ten-second delay so that market participants have the opportunity to determine if the value is not artificial. If the price does not come back in line, it would indicate market value is changing. As stated previously, this functionality worked as designed on May 6. With these safeguards in place, practices, such as buying the board, that may be considered disruptive should not be deemed to violate bids or offers unless there is manipulative intent. Then, and only then, should the Commission use its anti-manipulation authority to address disruptive practices.

In addition, the technology behind both trading automation and trading algorithms is specialized software that is often proprietary and complex in nature. Testing and monitoring such technically demanding systems requires knowledge of the intricacies of software and hardware, which can be unrelated to financial markets or economics and is often outside of the proficiency of most marketplace professionals. For this reason, it is important for regulators to clearly define the activities that are prohibited so that firms can program their systems to avoid such activities. A regulatory environment where any price correction, cancelled trade or market halt could lead to a federal enforcement action as a disruptive trading practice would deter trading by firms and their customers.

Trade-related technology and automation are fundamentally connected to the current market environment, and have become essential to its efficient functioning. The external behavior and affect of this technology are based on the instructions of the firms and individuals that implemented them and are already regulated through the same conduct rules and principles applicable to non-automated trading.

The Commission must recognize that any additional rules are likely to stifle financial innovation currently in everyday use with more technically advanced automation software that has in the last few decades broadly transformed the entire financial industry. The importance of financial innovation should not be underestimated when considering the substantial competitive advantages that technology has given the industry. Improved price discovery, reduced bid-ask spreads, reduced commissions and transaction costs, faster execution speeds, greater liquidity and increased market depth have all resulted from the use of technology in the financial industry. Technological innovation has also enhanced risk management, through the implementation of controls such as those highlighted by FIA's MAWG. For these reasons, the Commission should carefully consider whether any proposed rulemaking will negatively impact future innovation in the futures and derivatives markets.

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We appreciate the opportunity to provide comments to the Commission regarding Dodd-Frank Section 747, and we would be pleased to discuss any questions the Commission might have with respect to this letter. Any questions about this letter may be directed to Barbara Wierzynski, Executive Vice President and General Counsel at bwierzynski@futuresindustry.org or 202/466-5460.

Sincerely,

John M. Damgard
President

cc: Honorable Gary Gensler, Chairman
Honorable Michael Dunn, Commissioner
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner
Honorable Scott O'Malia, Commissioner

Division of Market Oversight
Robert Pease, Counsel to the Director of Enforcement
Mark Higgins Counsel to the Director of Enforcement