

Cross-Market Manipulation Allegations: Economic Implications

June 25, 2022



By **Yan Cao, Marlene Haas, and Greg Leonard**

Cross-market manipulation surveillance recently has garnered an increasing share of the international regulatory public spotlight. Compared to matters in which focused conduct (e.g., spoofing) is contained within a single market, fewer matters related to cross-market manipulation have been publicly pursued. However, regulators around the world, including the U.S., are now highlighting their continued focus on this type of market abuse, which is perceived to be more difficult to detect. In a cross-market manipulation scheme, traders allegedly place orders or undertake other activity in one product on an exchange or other trading venue with the intent of artificially impacting the related product trading on a different exchange or through a different venue. These related products have prices that are related to or correlated with the economics of the first product, or they may be derivatives linked to the first product.

While it has long been debated what attributes of cross-market trading activity may constitute manipulation rather than hedging or other legitimate conduct, recent years have brought new court decisions and announcements by regulators. Still, this question remains far from answered. For example, the U.S. Federal Energy Regulatory Commission (FERC) alleged that Etracom LLC perpetuated a cross-market manipulation of “electricity prices in the California wholesale electric market.”^[1] The FERC alleged that Etracom submitted “uneconomic” virtual supply offers “at the New Melones intertie at the border of the [California Independent System Operator (CAISO)] wholesale electricity market in order to affect wholesale power prices and economically benefit ETRACOM’s Congestion Revenue Rights

(CRRs) sourced at that location” during an approximately two-week period in May 2011.^[2] While CRRs do not trade within a wholly separate market, the FERC has referred to this case as a “cross-market manipulation” scheme based on the fact that Etracom engaged in “virtual transactions at the New Melones intertie not for any legitimate reason, such as arbitraging the difference between day-ahead and real-time prices, but rather with the intent to artificially lower the New Melones day-ahead LMP to benefit its CRR positions.”^[3] According to the FERC, Etracom lost over \$42,000 on its virtual supply offers in May while earning more than 12 times that amount as a result of its congestion revenue rights positions during the two-week period. A similar case was brought by the FERC against Vitol Inc. in 2020, also in the CAISO market.^[4]

In Europe, concerns about cross-market manipulation schemes appear to be central to regulators. For example, in November 2021, the U.K.’s Financial Conduct Authority (FCA) discussed its concern that some electronic execution platforms (especially in the fixed income and rates markets) do not require a “direct connection to users’ trading systems,” and that therefore the users of these platforms have “been unable to establish [a connection]” to report their orders and trades.^[5] The FCA is “concerned that users of web-based platforms may not be able to monitor all their orders to detect potential market abuse.” The FCA further highlights that orders are “a critical component in effective monitoring for some types of actual or attempted market manipulation” including “cross venue . . . manipulation.”^[6] If they do not have the capability to capture all executed and unexecuted orders, firms “may fail to identify this activity.”^[7]

With the recent increased global cross-market surveillance efforts and the continued focus by regulatory agencies, enforcement actions of cross-market manipulation from previous years shed light on how future matters potentially can be evaluated. This article discusses two such actions and their economic implications: *In the Matter of Michael D. Franko* and *In the Matter of Davis Ramsey*.

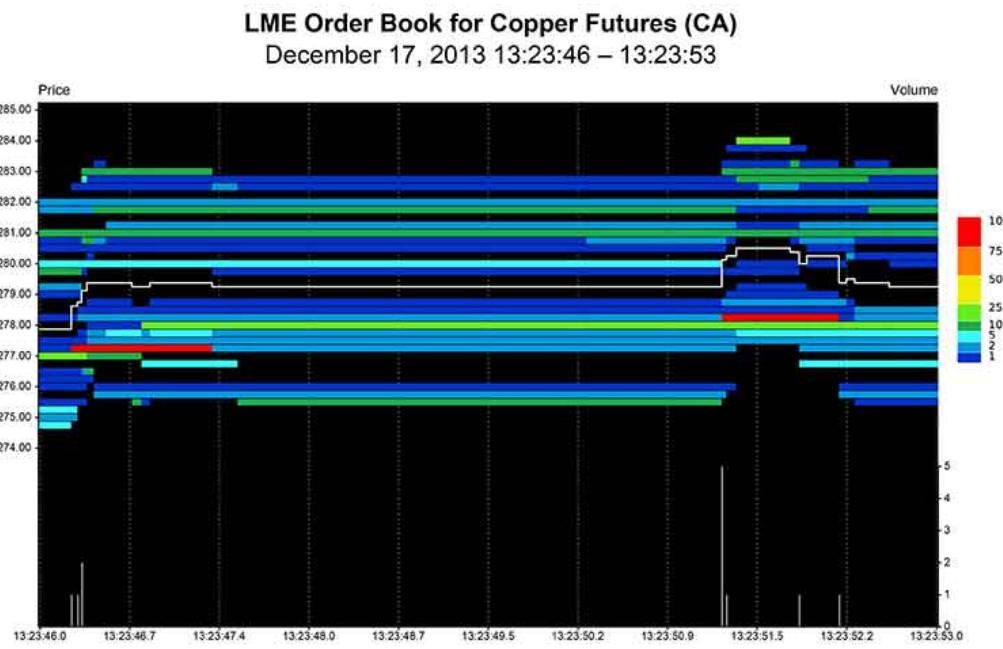
In the Matter of: Michael D. Franko

In September 2018, the U.S. Commodity Futures Trading Commission (CFTC) settled charges against Victory Asset Inc. and Michael D. Franko for spoofing and cross-market manipulation in U.S. and U.K. markets. The CFTC imposed civil monetary penalties on Victory and Franko of \$1.8 million and \$500,000, respectively.^[8] During the period of the alleged manipulative conduct, Franko was employed by one of Victory’s predecessor entities.

According to the CFTC, the cross-market scheme involved “spoofing in one market to benefit a position in another market, where the price of the two markets is generally correlated, particularly in the short term.”^[9] The CFTC found that Franko placed a relatively small bid or offer with the intent to execute that order in one market (e.g., on a U.S. commodities exchange) and then, prior to the execution of

the bona fide order, placed a larger order in a different market (e.g., on a U.K. commodities exchange) "with the intent to cancel that order before execution."^[10] For example, the CFTC determined that Franko placed one or more non-bona fide orders in copper futures on the U.K.-based London Metal Exchange (LME) to benefit a genuine order that he had placed in copper futures on the U.S.-based Commodity Exchange (COMEX), a designated contract market that is part of the CME Group. In doing so, he was allegedly "taking advantage of the correlation in price between these markets."^[11]

In its order, the CFTC provides an example of how "Franko's Spoof Orders were designed to create or exacerbate order book imbalance in the Relevant Markets, for the benefit of his Genuine Orders."^[12] For this example, the CFTC provides the date at issue (December 17, 2013) as well as information on price levels and quantities of orders, but does not provide the precise timestamps. An analysis of the COMEX and LME copper futures data on December 17, 2013, shows that there is one instance that matches significant aspects of the example trading pattern as identified by the CFTC.^[13] Figure 1 illustrates the pattern described for LME copper futures. Around 13:23:46 UTC, 100 contracts were placed on the LME at the second best bid of \$7,277.25. According to the CFTC, shortly before placing the bid order for 100 contracts on the LME, Franko placed two sell orders of 11 contracts each on COMEX. The two sell orders were "iceberg orders that only showed to the market as one lot."^[14] The two sell orders were fully and partially filled, respectively, while the bid order of 100 contracts was outstanding on the LME.

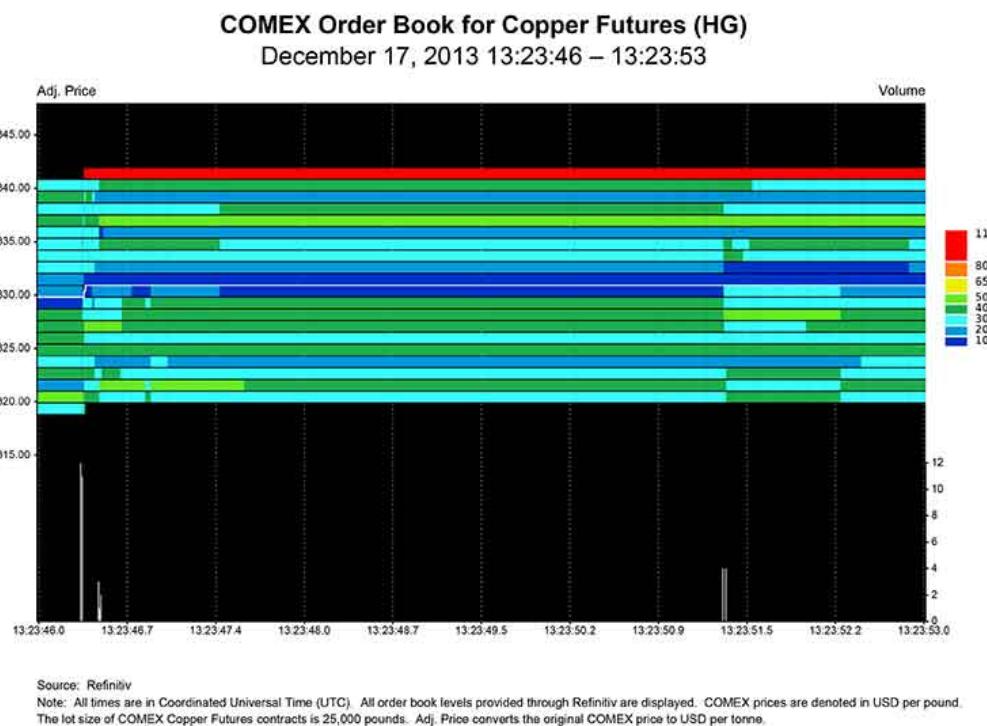


Source: Refinitiv
Note: All times are in Coordinated Universal Time (UTC). All order book levels provided through Refinitiv are displayed. LME prices are denoted in USD per tonne.
The lot size of LME Copper Futures contracts is 25 tonnes.

Approximately one second after placing his bid order on the LME, Franko cancelled it. He then placed a second buy order for 100 contracts "that was at a higher price than his previous Spoof Order, but, because of market movement, it was placed at the third best bid."^[15] This is shown in Figure 1, at 13:23:51 UTC, when the red bar representing 100 contracts appears on the LME at the third best bid of

\$7,278.25. While this second order was active, “five more lots on Franko’s Second Genuine Order were filled” on COMEX. Then, approximately one second after placing it, he cancelled his second “Spoof Order.”^[16]

The concurrent market activity on COMEX is shown in Figure 2. In particular, the order book on COMEX shows an upward movement of one price level approximately concurrent to the upward movement on the LME. Figure 2 also shows executions that fit the trading pattern described by the CFTC.



In the Matter of Davis Ramsey

In September 2018, the CFTC imposed remedial sanctions against and accepted a settlement with Davis Ramsey for cross-market manipulation in binary contracts and related futures contracts.^[17] The CFTC imposed civil monetary penalties on Ramsey of \$325,000.^[18]

According to the CFTC, the cross-market scheme involved taking a “position in one or more Binary Contracts [US 500 Binary Contracts] for which the outcome at expiration . . . was determined based on the price of certain futures contracts that were traded on either COMEX or CME.”^[19] Ramsey would then “place trades on CME in the relevant futures contracts . . . with the intent and in a manner designed to impact the price of those futures contracts to achieve his further objective, which was to influence the settlement of the Binary Contracts in his favor.”^[20] The Binary Contracts traded on the Northern American Derivatives Exchange (Nadex), which is a source of liquidity and market wholly separate from the CME on which the related futures contracts traded.

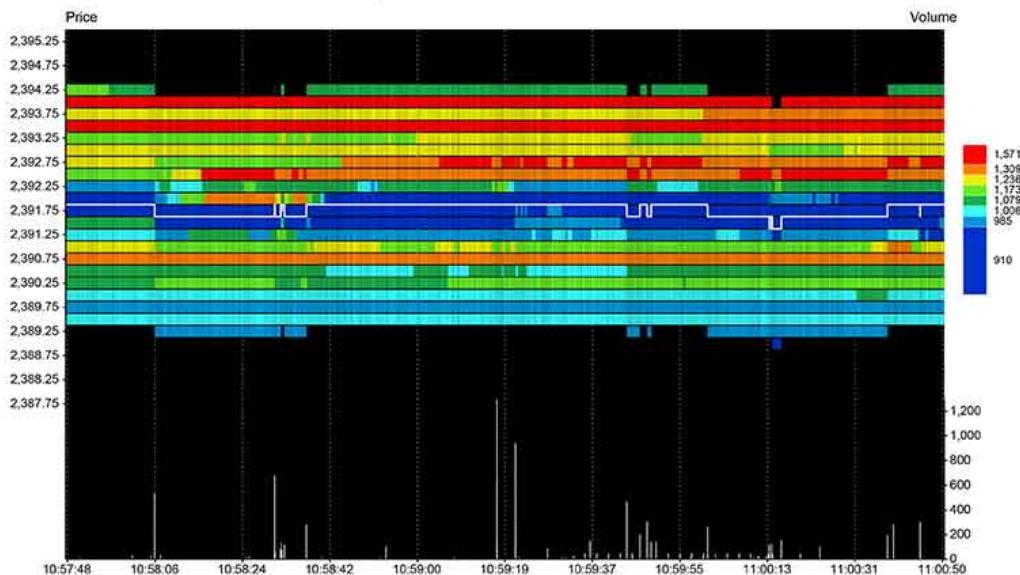
The CFTC found that Ramsey traded Binary Contracts with certain futures as the underlying. While having an open position in Binary Contracts immediately prior to

the expiration of the Binary Contracts, Ramsey traded in the underlying futures contracts. According to the CFTC, Ramsey "entered into these transactions with the intent to influence the Futures prices that would be used to calculate the relevant Binary Contract Expiration Value."^[21] He placed "multiple small . . . orders at prices that would cause his Binary Contracts to expire in-the-money."^[22] After the expiration of the Binary Contracts, he would close his futures position.

The CFTC found "at least one occasion during the Relevant Period" when Ramsey's strategy caused "certain Futures contracts on CME to trade at an artificial price just prior to a Binary Contract Expiration for positions" that Ramsey held in his trading accounts with Nadex, which were wholly separate from his trading accounts with CME.^[23] The CFTC points to an example from May 10, 2017, when Ramsey bought Binary Contracts written on the CME S&P 500 E-mini futures. The payoff criterion for these Binary Contracts was 2391.95—that is, if the E-mini futures exceeded this price level, the Binary Contracts would have been in-the-money and therefore valuable for traders who purchased this contract. The payoff criterion is determined by Nadex based on the average price of the E-mini futures for the 25 trades leading up to 11:00 AM ET (disregarding the bottom and top five trades). According to the CFTC, because "the June S&P E-mini trades in 25 cent increments . . . , for the Binary Contract Expiration Value to be above 2391.95, of the [15] trades used to calculate the average, at least [13] . . . would have to be at a price of 2392 with the remaining two trades at a price of 2391.75."^[24]

Between 10:57:48 AM ET and 10:57:53 AM ET, Ramsey bought a total of 70 Binary Contracts. Approximately two seconds later, at 10:59:44 AM ET, he started placing one-lot orders in the June S&P E-mini futures. Ramsey placed all of his orders at a price level of 2392.^[25] Figure 3 illustrates the pattern described for the S&P E-mini futures. During the period in which Ramsey was trading, the June S&P E-mini futures contract had traded between 2391.5 and 2391.75. In total, Ramsey placed and executed 82 separate one-lot buy orders. Figure 3 shows in more detail how the market moved at the time of Ramsey's trading. In particular, the order book on CME shows an upward movement of one price level around the time when Ramsey started to place marketable buy orders. Figure 3 also shows executions that fit the trading pattern described by the CFTC.

CME Order Book for June S&P 500 E-mini Futures
May 10, 2017 10:57:48 – 11:00:50



Source: Refinitiv

Note: All times are in Eastern Time (ET). All order book levels provided through Refinitiv are displayed. CME S&P 500 E-mini prices are denoted in USD per index point. The lot size of the CME S&P 500 E-mini futures is \$50 x S&P 500 Index.

According to the CFTC, as “a result of Ramsey’s CME trading, his Binary Contracts [on Nadex] did expire in the money.”^[26] The CFTC also found that the 25 trades that were used by Nadex to determine the expiration value of the Binary Contracts “included [18] trades at a price of 2392,” 16 of which were executed by Ramsey.^[27] The final expiration value of the Binary Contracts was 2391.967. Overall, the CFTC found that during the period when Ramsey engaged in this strategy, he made a profit of “at least \$250,636.25” across his Nadex accounts.^[28]

Conclusion

Regulatory surveillance functions and capabilities are evolving to monitor for market abuse risks spanning multiple contracts and products across separate trading venues. While the landscape of cross-market manipulation prosecutions and enforcement actions is evolving, recent actions taken by courts and regulators signal the commitment to include cross-market manipulation law enforcement in the broader enforcement of general market abuse regulation. In the *Franko* and *Ramsey* matters, the traders employed similar trading strategies (entering of allegedly non-bona fide orders in one market to affect genuine orders in another) across multiple, highly correlated venues and instruments. Thus, these matters provide insights and guidance relevant for evaluating future cross-market manipulation enforcement investigations.

About the Authors

Greg Leonard, is a senior vice president at Cornerstone Research in London and Washington, D.C. **Yan Cao** is a vice president at Cornerstone Research in New York. **Marlene Haas** is a senior manager at Cornerstone Research in Washington, D.C. The views expressed in this article are solely those of the authors, who are responsible for the content, and do not necessarily represent the views of Cornerstone Research or any of its clients.

References

- [1] Federal Energy Regulatory Commission v. Etracom LLC et al., Case Number 2:16-at-01011.
- [2] Federal Energy Regulatory Commission v. Etracom LLC et al., Case Number 2:16-at-01011, ¶ 4.
- [3] Federal Energy Regulatory Commission v. Etracom LLC et al., Case Number 2:16-at-01011, ¶ 52.
- [4] Federal Energy Regulatory Commission v. Vitol Inc. et al., Case Number 2:20-cv-00040.
- [5] "Newsletter on Market Conduct and Transaction Reporting Issues," Market Watch 68, November 2021, <https://www.fca.org.uk/publications/newsletters/market-watch-68> ("Market Watch 68").
- [6] Market Watch 68.
- [7] Market Watch 68.
- [8] "CFTC Orders Futures Trader and Trading Firm to Pay \$2.3 Million in Penalties for Cross-Market and Single-Market Spoofing and Manipulative Scheme," CFTC, September 19, 2018, <https://www.cftc.gov/PressRoom/PressReleases/7796-18> ("CFTC Victory/Franko Press Release").
- [9] CFTC Victory/Franko Press Release.
- [10] CFTC Victory/Franko Press Release.
- [11] CFTC Victory/Franko Press Release.
- [12] Order Instituting Proceedings Pursuant to Section 6(c) and (d) of the Commodity Exchange Act, Making Findings and Imposing Remedial Sanctions, In the Matter of: Michael D. Franko, CFTC Docket No.: 18-35, September 19, 2018 ("CFTC Order Franko").
- [13] See CFTC Order Franko, p. 3. To identify instances that match the example trading pattern within the relevant period as identified by the CFTC, COMEX and LME data as provided by Refinitiv were screened for the order submission pattern described in the CFTC's Order.
- [14] See CFTC Order Franko, p. 3.
- [15] See CFTC Order Franko, p. 3.
- [16] See CFTC Order Franko, p. 3.
- [17] Order Instituting Proceedings Pursuant to Section 6(c) and (d) of the Commodity Exchange Act, Making Findings and Imposing Remedial Sanctions, In the Matter of: Davis Ramsey, CFTC Docket No.: 18-49, September 27, 2018 ("CFTC Order Ramsey").
- [18] See CFTC Order Ramsey, p. 9.
- [19] See CFTC Order Ramsey, p. 2.
- [20] See CFTC Order Ramsey, p. 2.
- [21] See CFTC Order Ramsey, p. 4.
- [22] See CFTC Order Ramsey, p. 4.
- [23] See CFTC Order Ramsey, p. 4.
- [24] See CFTC Order Ramsey, p. 4.
- [25] See CFTC Order Ramsey, pp. 4–5.
- [26] See CFTC Order Ramsey, p. 5.
- [27] See CFTC Order Ramsey, p. 5.
- [28] See CFTC Order Ramsey, p. 6.