The Harvard Law School Forum on Corporate Governance and Financial Regulation

Increased Scrutiny of High-Frequency Trading

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Editor's Note: The following post comes to us from Matthew Rossi, partner in the Securities Litigation & Enforcement practice at Mayer Brown LLP, and is based on a Mayer Brown Legal Update by Mr. Rossi, Joseph De Simone, and Jerome J. Roche. The complete publication, including footnotes, is available here.

Following the publication of Michael Lewis' new book, *Flash Boys: A Wall Street Revolt* ("*Flash Boys*"), plaintiffs' lawyers and US government regulators have increasingly focused their attention on financial institutions participating in high-frequency trading ("HFT"). Less than three weeks after the release of *Flash Boys*, private plaintiffs' lawyers filed a class action lawsuit against 27 financial services firms and 14 national securities exchanges (with additional defendants likely to be named later) alleging that the defendants' HFT practices in the US equities markets violated the anti-fraud provisions of the federal securities laws. Plaintiffs' lawyers filed a separate action against The CME Group, Inc. ("CME") and The Board of Trade of the City of Chicago ("CBOT") containing similar allegations in US derivatives markets.

In addition, the US Securities and Exchange Commission ("SEC"), Commodity Futures Trading Commission ("CFTC") and Federal Bureau of Investigation ("FBI") announced that they were actively investigating HFT practices. The New York State Attorney General is currently pursuing an initiative to crack down on what he referred to as "unseemly practices" in the HFT business. Thus, it is clear that trading firms, brokers, and exchanges engaged in HFT activity are coming under increasing pressure in the US from private litigants, securities regulators and criminal law enforcement authorities. As HFT techniques are increasingly used in non-US markets, the strategies and tactics used by private litigants and regulators in the United States may soon be exported outside of the United States as well.

Private Litigation

On April 18, 2014, in *City of Providence, Rhode Island v. BATS Global Markets, Inc. et al* ("*City of Providence*"), private plaintiffs sued 12 high-frequency proprietary trading firms, 14 national

securities exchanges and 15 brokerage firms in a federal class action for purportedly violating the anti-fraud provisions of the federal securities laws. Plaintiffs allege that defendants engaged in a fraudulent scheme to provide high-frequency proprietary trading firms with material nonpublic information that those firms used to manipulate the United States stock market. According to the plaintiffs, the defendants purported scheme violated Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Exchange Act Rule 10b-5. Plaintiffs further claim that the brokerage and high-frequency proprietary trading firms violated Exchange Act Section 20A by engaging in insider trading, and that the exchanges violated Exchange Act Section 6(b) by deliberately failing to operate in the public interest, for the protection of investors and in a fair and equitable manner. Significantly, the plaintiffs seek certification not only of a plaintiff class but also a defendant class that they contend includes hundreds of financial firms not currently named in the action. Thus, it is likely that the plaintiffs will attempt to add additional defendants in the case.

The *City of Providence* case comes on the heels of a separate private class action filed one week earlier against CME and CBOT. In that case, the plaintiffs allege that CBOT and CME charged high-frequency proprietary trading firms for the ability to obtain price and order information before all other market participants, and that they allowed the firms to trade using that purportedly nonpublic information. The plaintiffs further maintain that the defendants charged other market participants for "real time" market data without disclosing that the data had previously been provided to high-frequency proprietary trading firms. According to the plaintiffs, this alleged conduct violates Sections 1, 4, 6, and 9 of the Commodities Exchange Act.

SEC, CFTC and FBI

Government regulators are also scrutinizing HFT practices. On May 1, 2014, the SEC imposed penalties on The New York Stock Exchange, LLC ("NYSE") for a number of violations, including the manner in which it offered "co-location" services. On April 29, 2014, SEC Chair Mary Jo White testified before Congress that the SEC has numerous ongoing investigations into practices by high-frequency traders and dark pools. She also explained that high-frequency and algorithmic trading will be a focus of the SEC's National Exam Program. SEC Enforcement Director Andrew Ceresney further warned, in a separate speech to industry members, that, "the Enforcement Division has a number of ongoing investigations into HFT and automated trading to ferret out possible abuses such as market manipulation, spoofing and related issues." The acting chairman of the CFTC similarly indicated that the agency is reviewing HFT practices to see if they constitute "spoofing" or other manipulative conduct that could violate the Commodities Exchange Act or CFTC rules.

On April 4, 2014, US Attorney General Eric Holder confirmed in Congressional testimony that the Department of Justice was also investigating whether HFT practices violate insider trading laws. The Attorney General's testimony came a few days after the *Wall Street Journal* reported that the FBI is investigating HFT related practices, including whether high-frequency proprietary trading firms are using nonpublic information to front run orders placed by other investors or are placing groups of orders and then cancelling them to create the false appearance of market activity.

State Regulators

State attorneys general have also set their sights on HFT. Reuters reported on May 2, 2014, that the New York State Attorney General's office is expected to issue subpoenas to exchanges and alternative trading platforms to gather data on the manner in which high-frequency proprietary trading firms obtain information. This planned action is likely part of a larger investigation into HFT that the New York Attorney General, Eric Schneiderman, announced in March 2014. In addition, the office of the Secretary of the Commonwealth of Massachusetts sent a survey to 1070 investment advisers in the state, including advisers to hedge funds and private equity firms, asking for information about their HFT practices. The survey includes questions about the use of co-location and direct data feed services. It also asks firms to briefly describe any HFT strategies they employ.

Although federal and state authorities have been conducting inquiries into HFT for some time, the publication of *Flash Boys*, and its attendant publicity have significantly raised the stakes for government investigations. It may also encourage private plaintiffs to file additional actions against high-frequency proprietary trading firms, exchanges and brokerage firms.

Market Manipulation

Private plaintiffs and regulators will likely focus their attention on high-frequency proprietary trading firms pursuing strategies that resemble traditionally prohibited forms of market manipulation such as spoofing, layering, marking the close and painting the tape. Spoofing and layering occurs "when a trader creates a false appearance of market activity by entering multiple non-bona fide orders on one side of the market, at generally increasing (or decreasing) prices, in order to move that stock's price in a direction where the trader intends to induce others to buy (or sell) at a price altered by the non-bona fide orders." Marking the close is a strategy that "involves the placing and execution of orders shortly before the close of trading on any given day to artificially affect the closing price of a security." Painting the tape is the placing of "successive, small-amount buy orders in increasing prices to simulate increased demand." The SEC has long contended that these practices violate Exchange Act Sections 9(b) and 10(b) as well as

Exchange Act Rule 10b-5. As recently as April 4, 2014, the SEC imposed an industry bar and monetary sanctions of $1.9 million on the owner of a trading firm for misconduct that included spoofing and layering.

"Quote stuffing" and "price fade" are additional HFT practices that may attract attention from regulators and plaintiffs lawyers. Quote stuffing is a strategy that "floods the market with huge numbers of orders and cancellations in rapid succession, … creating a large number of new best bids or offers, each potentially lasting mere microseconds." This tactic may be used to generate buying or selling interest in certain securities or compromise the trading decisions of other market participants by forcing them to process false order information. Order fade—sometimes referred to as price fade—is a trading practice that involves the rapid cancellation of orders in response to other trades. It results in "volume disappearing immediately after a trade on the same venue."

High-frequency proprietary trading firms that engage in strategies similar to any of these practices may face examination, investigation and perhaps, enforcement action from regulators, in addition to private plaintiff actions.

Insider Trading

The plaintiffs in *City of Providence* allege that high-frequency proprietary trading firms engaged in insider trading by using material nonpublic information obtained through co-location and individual direct data feed arrangements with exchanges. Co-location is a service whereby a trading center "rents … space to market participants that enables them to place their servers in close physical proximity to a trading center's matching engine. Co-location helps minimize … [latency times] between the matching engine of trading centers and the servers of market participants."

Exchanges also sell data feeds that deliver order and trade information directly to individual customers. In addition, exchanges generally report their trades and best-priced orders to the consolidated tape which is widely available to the public. The individual data feeds contain the same information as the consolidated tape and may include additional information such as quotations at prices inferior to an exchange's best-priced quotations.

Significantly, the SEC does not prohibit exchanges from offering co-location and direct data feed services. In fact, it allows and regulates those services. The SEC requires that exchanges offering co-location and direct data feeds do so on terms that are "fair and reasonable," and not "unreasonably discriminatory." Exchanges offering co-location services must also have an SEC-approved exchange rule in place governing those services. Moreover, Regulation NMS Rule 603(a) prohibits exchanges from independently transmitting their own data any sooner than they transmitted data to a processor for inclusion in the consolidated tape. The SEC has expressly

acknowledged that, under Rule 603(a) of Regulation NMS, information in the individual data feeds of exchanges generally reaches market participants faster than the same information in the consolidated tape because of the time required to consolidate data from multiple exchanges and distribute it to the public.

During recent Congressional testimony, Representative Garrett asked SEC Chair Mary Jo White, “Does the use of what you call an exchange data feed which is approved by the SEC, to make changes to your bids, does that … constitute insider trading.” Chair White responded, “If properly used, no.”

High-frequency proprietary trading firms facing allegations of insider trading may be able to use these facts to argue that market information obtained through co-location and direct data feed arrangements is public information. Exchanges must, however, be careful to comply with all applicable rules regarding co-location and direct data feeds. On May 1, 2014, the SEC brought an enforcement action against the NYSE for, among other things, offering co-location without any SEC approved exchange rule in place governing that service. The SEC also brought an enforcement action against the NYSE in 2012 for violating Regulation NMS Rule 603 by providing information to individual data feeds before sending it to the processor for inclusion in the consolidated tape.

Order Flow Payments

The *City of Providence* plaintiffs also claim that some brokerage firms failed to obtain best execution for their customer orders and otherwise engaged in securities fraud by routing customer orders to trading venues in exchange for allegedly undisclosed order flow payments. It is important to note, when evaluating this claim, that brokers are usually required to disclose order flow payments. Regulation NMS Rule 606 requires brokers to report quarterly on their order routing and to make those reports available to the public. The reports must include the venues where significant amounts of orders were executed, the broker’s relationship with each venue, and any compensation arrangements like payment for order flow or profit sharing.

Exchange Act Rule 10b-10 also generally requires a broker to disclose on trade confirmations it provides to each customer whether it received payment for order flow with respect to US-exchange traded equities. These trade confirmations must also inform the customer that the broker will, upon written request, furnish the source and nature of that order flow compensation. It is critical for brokers to comply with all of these requirements to maximize their defense against claims like those in the *City of Providence* case and avoid regulatory enforcement action. Of course, brokerage firms must also comply with their duty of best execution.

Conclusion

Federal and state law enforcement authorities are actively investigating HFT. Private plaintiffs have begun class action litigation against exchanges, brokerage firms and proprietary trading firms engaged in HFT. The private plaintiffs have also signaled their intent to bring HFT related claims against additional financial services firms not currently included in existing actions. Moreover, as HFT techniques are increasingly used in non-US markets, the strategies and tactics of private litigants and regulators in the US may soon be exported abroad.

It is critically important in this environment for US equity and derivatives market participants to be mindful of their HFT practices. High-frequency proprietary trading firms must continue to avoid trading strategies that resemble traditionally prohibited forms of market manipulation. Exchanges should continue to be conscientious about complying with all SEC rules governing co-location and data feed services. Brokerage firms should similarly continue to comply with all applicable regulations requiring disclosure of order flow payments and seeking best execution of customer orders. All financial services firms that participate in HFT activity will also need experienced counsel to help them respond to increased regulatory inquires and potential private litigation arising from HFT.