

## Securities Regulation Daily Wrap Up, FRAUD AND MANIPULATION— N.D. Ill.: Traders allege CME Group gave high-frequency traders an unfair advantage, (Apr. 14, 2014)

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By Lene Powell, J.D.

Three commodity futures traders brought a class action lawsuit against CME Group, Inc. for allegedly allowing high-frequency traders (HFTs) to see price and market data before other market participants and to use this data to execute trades before other traders. In facilitating the “hyper-scalping” by HFTs, the CME Group and its subsidiary, the Chicago Board of Trade (CBOT), engaged in a fraud on the marketplace and deceptive practices and failed to maintain a marketplace free from market disruption and market manipulation, said the complaint (*Braman v. The CME Group Inc.*, April 11, 2014).

In a statement, the CME Group said the case was without merit and it would defend itself vigorously. “The suit is devoid of any facts supporting the allegations and, even worse, demonstrates a fundamental misunderstanding of how our markets operate,” said the group.

The suit comes amid widespread discussion of high-frequency trading due to the recent publication of the popular book *Flash Boys* by Michael Lewis, which critically examines HFT practices. Financial regulators have also turned their attention to HFTs.

**HFTs allowed to see, execute orders before others.** The complaint defines HFTs as “generally computers” that make trades as fast as thousandths of a second. According to the complaint, starting in 2007, the defendants began to allow HFTs to peek at all orders to buy and sell futures contracts before they were reflected in the public order book, before the person or entity entering the buy or sell order received confirmation that their order was received. The defendants allowed HFTs to enter and/or execute orders to buy and sell futures contracts based on the price information of all non-HFTs, putting the HFTs in an exclusive position to profit.

Because HFTs generally enter very large orders, said the complaint, they have the ability through their “*de facto* insider trading” to artificially influence the price of financial futures, creating a distorted marketplace. By “inviting” HFTs to execute trades ahead of others using the market data they were exclusively privy to—selectively allowing the front-running of orders—the defendants “institutionalized market manipulation” and created an opaque and hidden marketplace for financial futures. The complaint clarified that it was not the speed itself that the plaintiffs objected to, but rather the granting of price data to a select group of market participants, creating a two-tiered, unequal marketplace.

**Clandestine contracts.** The CME Group and CBOT entered into “clandestine contracts” with HFTs, knowing that the activities of HFTs would adversely affect all other individuals and entities that traded the exchanges’ futures contracts, the complaint alleged. The CME Group and CBOT never revealed that they had given HFTs a first glance at price data. The defendants advertised on their websites that co-located servers gave a speed advantage but did not say that HFTs also had the competitive advantage of the ability to act on price data before other market participants, even those who paid for collocation services. The defendants’ chairman and CEO repeatedly gave false information to the public, touting the alleged benefits of HFT for price and liquidity, without ever mentioning they were giving HFTs an unfair advantage, the traders contended.

**Class action.** The traders brought the suit in the federal district court for the Northern District of Illinois as a class action on behalf of persons and entities that: (1) directly or indirectly paid for real-time data and price information for futures and options contracts listed by the CME Group; and (2) paid exchange fees to trade futures and options contracts. The complaint asserted that, due to the large number of class members, joinder would be impracticable. Further, common issues of fact or law predominate over individual issues, the complaint said.

The traders alleged that the defendants engaged in “active market manipulation” in violation of Secs. 9(a) and 22(a) of the Commodity Exchange Act (CEA) and facilitated for-profit transactions that caused artificial prices

to be recorded in violation of CEA Sec. 4c. The defendants also cheated, defrauded, and willfully deceived the traders and the putative class, violating CEA Section 4b.

The suit seeks unspecified damages and the recovery of money paid to the defendants for real-time market data and order information. The plaintiffs demanded a jury trial.

**Regulatory scrutiny of HFTs.** The SEC recently released a report that summarized economic papers examining HFTs. The report found that primarily passive high-frequency trading strategies appear to have beneficial effects on market quality, such as by reducing spreads and reducing intraday volatility on average. In contrast, primarily aggressive strategies raise more potential issues with positive and negative aspects.

At a recent meeting of the SEC Investor Advisory Committee, SEC Chair Mary Jo White said that high-frequency trading did not raise any new issues but raised questions as to whether it creates unfair advantages. A market structure review is important to determine whether any changes are necessary, said White.

Recently departed CFTC Commissioner Bart Chilton frequently called for greater attention to HFTs, whom he called “cheetahs” due to their speed and “aggressive behavior.” Chilton supported H.R. 2292, a bill introduced in 2013 by Rep. Edward Markey (D-Mass.) that would require HFTs involved in commodities to register with the CFTC, would ban simultaneous buy and sell orders, and would give the CFTC general power to regulate HFTs. It would also give the CFTC the power to fine HFTs based on the amount of time of their violation and increase the penalties for market manipulation.

U.S. Attorney General Eric Holder and New York Attorney General Eric T. Schneiderman have also expressed concerns about high-frequency trading. Schneiderman has called it “insider trading 2.0.”

The case is No. 1:14-cv-02646.

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Companies: Chicago Board of Trade; CME Group, Inc.

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