Securities Regulation Daily Wrap Up, TOP STORY—S.D.N.Y.: City of Providence brings class action against exchanges, brokerages, proprietary firms for market manipulation via high frequency trading, (Apr. 22, 2014)

Securities Regulation Daily Wrap Up

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By Lene Powell, J.D.

The city of Providence, Rhode Island, sued a group of major securities exchanges, brokerages, and proprietary trading firms in a putative class action on behalf of all investors who bought or sold stock on a public exchange since 2009, contending that the defendants manipulated the U.S. securities markets and diverted billions of dollars from buyers and sellers of securities to themselves, in violation of the Exchange Act. The complaint alleges that exchanges and alternative trading venues received "substantial kickback payments" in exchange for providing high frequency trading (HFT) traders access to material trading data via preferred access to exchange floors and/or through proprietary trading products. The action also accuses brokerages of providing HFT traders access to customers' bids and offers and directing trades to stock exchanges and alternative trading venues they knew were "rigged." Brokerages sold "special access" to material data, including orders made by investors, so that HFT traders could trade against them using informational asymmetries and other market manipulation (*City of Providence v. BATS Global Markets*, April 18, 2014, Wood, K.).

The lawsuit comes in the wake of a similar lawsuit against the CME Group and increased public attention to HFT due to the popular book *Flash Boys* by Michael Lewis, which critically examines HFT practices. SEC Chair Mary Jo White has said a market structure review is important to determine whether any changes are necessary.

HFT. The complaint defines HFT as a type of algorithmic trading used to rapidly trade securities, executing strategies carried out by computers to move in and out of positions in milliseconds or even microseconds. Many of the largest financial institutions have in-house HFT divisions, and there are also dedicated HFT firms. The latter represent just 2 percent of the approximately 20,000 operating firms but account for 73 percent of all equity bids and order volume. HFT traders execute on very few of the bids and orders they place, often placing them for only seconds to discover the intentions of other traders. Since 1999, while stock market volume has only slightly more than doubled, the number of quotes has gone up by 2000 times, asserts the complaint.

The complaint describes a number of trading strategies used by HFT traders. In trading ahead, algorithms anticipate and trade ahead of stock price movements caused by mutual fund rebalancing, profiting from advance knowledge of the large institutional block orders. In electronic front-running, HFT traders use preferred access to material trade data to identify large orders being broken into smaller parts, buying the relevant security elsewhere and selling it back to the institutional investor at increased prices. In a strategy called slow-market arbitrage, HFT traders use speed to gain minuscule advantages in arbitraging price discrepancies in a particular security trading simultaneously on different markets. Other strategies include spoofing and layering, which use orders that a trader does not intend to have executed, which are designed to induce others to buy or sell a security at a price not representative of actual supply and demand.

Most HFT does not occur on public exchanges and is not regulated by the SEC, said the complaint. Only 70 percent of trading happens on public exchanges—the rest takes place inside large, in-house alternative trading venues that match buy and sell orders internally. On these venues, also called "dark pools," neither the size of the trade nor the identity is revealed until the trade is filled. Many brokers put customer orders/bids from "main street investors" into the alternative trading venues and leave them sitting there. This allows the traders of the financial firm that operates the alternative trading venue, and any firms paying those operators for access to

that data, to trade against the interests of the broker's customers by placing bids/orders on other exchanges to discover pricing availability, transacting at the optimal price, then coming back and transacting with the broker's customers to the customers' disadvantage, the complaint contends.

Exchange Act claims. The complaint alleges that the defendants' execution of HFT strategies violate three sections of the Exchange Act. First, according to the complaint, the defendants violated Section 10(b) and Rule 10b-5 by participating in a fraudulent scheme and wrongful course of business that operated as a fraud or deceit on the investing public, including members of the class. They wrongfully misappropriated material, nonpublic information about investors' intentions to trade, tipped one another to those intentions, and otherwise distorted and manipulated the pricing of securities. As a result, the trading prices of the securities bought or sold on exchanges during the class period were distorted, and class members were damaged by buying and/or selling securities at the artificially manipulated prices.

Second, the complaint contends that the exchange defendants violated Section 6(b) by failing to operate their securities exchanges in the public interest and for the protection of investors and by failing to ensure that the exchanges were operated in a fair and equitable manner. This conduct did not result from ordinary or even gross negligence but instead from the exchange defendants' active furtherance and participation in the scheme and wrongful course of business and was undertaken for the exchanges' own economic gain. The complaint alleges that the plaintiff class was damaged as a result of the conduct and that the exchange defendants improperly profited and were enriched.

Finally, the complaint argues that the brokerage and HFT defendants violated Section 20A by buying and selling shares while in possession of adverse, material, nonpublic information and profiting thereby. The defendants knew they were engaging in predatory trading that was distorting market prices, while the plaintiff class did not and was damaged.

According to the complaint, the members of the plaintiff class are so numerous that joinder would be impracticable; the plaintiff's claims are typical of the claims of class members; and common questions of law and fact predominate over any questions solely affecting individual members of the class.

Relief sought. The complaint requests that the action be declared a class action and that compensatory damages and equitable restitution be awarded to the investors, as well as fees and costs. The complaint also seeks equitable relief, including, among other measures: imposing a constructive trust or asset freeze on defendants' illicit trading proceeds; prohibiting HFT traders from engaging in electronic front-running or other specified strategies; prohibiting brokerage firms from transacting in alternative trading venues on behalf of customers; and prohibiting exchange defendants from providing an informational advantage to HFT traders via co-location of servers operated by HFT defendants within the facilities of public stock exchanges.

The case is No. 14 cv 2811.

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Companies: BATS Global Markets, Inc.; BOX Options Exchange LLC; Chicago Board Options Exchange, Inc.; Chicago Stock Exchange, Inc.; C2 Options Exchange, Inc.; Direct Edge ECN, LLC; International Securities Exchange Holdings, Inc.; The NASDAQ Stock Market LLC; NASDAQ OMX BX, Inc.; NASDAQ OMX PHLX, LLC; National Stock Exchange, Inc.; New York Stock Exchange, LLC; NYSE Arca, Inc.; OneChicago, LLC; Bank of America Corporation; Barclays PLC; Citigroup Inc.; Credit Suisse Group AG; Deutsche Bank AG; The Goldman Sachs Group, Inc.; JPMorgan Chase & Co.; Morgan Stanley & Co. LLC; UBS AG; The Charles Schwab Corporation; E*TRADE Financial Corporation; FMR, LLC; Scottrade Financial Services, Inc.; TD Ameritrade Holding Corporation; Citadel LLC; DRW Holdings, LLC; GTS Securities, LLC; Hudson River Trading LLC; Jump Trading, LLC; KCG Holdings, Inc.; Quantlab Financial LLC; Tower Research Capital LLC; Tradebot Systems, Inc.; Tradeworx Inc.; Virtu Financial Inc.; Chopper Trading, LLC.

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