Securities Regulation Daily Wrap Up, EXCHANGES AND MARKET REGULATION—S.D.N.Y.: Advantages provided to 'Flash Boys' not a matter for the court, (Aug. 27, 2015)

Securities Regulation Daily Wrap Up

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By Matthew Garza, J.D.

Seven stock exchanges and British bank Barclays escaped a suit filed by investors over their facilitation of high frequency trading. Despite their status as for-profit corporations eager to attract high volume traders, the exchanges remain self regulatory organizations with absolute immunity from private suits related to their oversight duties, held the court. Their operations, and those of Barclays in running its alternative trading system, also did not amount to market manipulation under Exchange Act Section 10(b). The court dismissed four suits in the multi-district litigation but allowed leave to amend in a fifth action brought under California law by Great Pacific Securities (*In re Barclays Liquidity Cross and High Frequency Trading Litigation*, August 26, 2015, Furman, J.).

Background. The action was brought against the New York Stock Exchange, NYSE Arca, NASDAQ, NASDAQ OMX BX, BATS Global Markets, Chicago Stock Exchange, Direct Edge ECN, and Barclays Capital Inc., the subsidiary that operates the British bank's dark pool. Judge Furman noted that these defendants faced a litany of lawsuits after the 2014 publication of "Flash Boys" by Michael Lewis, which argued that exchanges and dark pools put average investors at an unfair disadvantage by enabling high speed trading. The judge said that Lewis could be right that high frequency trading merely exploits technological inefficiencies at the expense of ordinary traders, but that wider debate is more properly treated as a regulatory matter for the SEC or entities such as the exchanges and Barclays. Arguments made by the parties were further detailed in the *Securities Regulation Daily Wrap Up* on November 4, 2014.

Regulation NMS. The court recounted the SEC's efforts to unify trading through the 2005 adoption of Regulation NMS, which among other things, required exchanges to put in place measures to prevent the execution of trades at prices inferior to prices displayed by other exchanges (known as the "order protection rule"). Regulation NMS requires exchanges to transmit a real-time feed of information on transactions to a central processor, which is consolidated and used to establish a national best bid and offer (NBBO).

Since the adoption of Regulation NMS, high-frequency trading has soared from about 10 percent of the total orders placed in the early 2000s to nearly 75 percent today. According to the plaintiffs, this "predatory" and "toxic" high-frequency trading uses computer-driven algorithms to move quickly in and out of positions to exploit the trading strategies of ordinary investors, who are forced to trade at less advantageous prices. The delta, or the price an ordinary investor would have traded at but for the high-frequency trading, goes to the HFT firm.

Exchange operations. Three features of the exchanges' operations were targeted by the investors: (1) Proprietary data feeds that sometimes include additional or more detailed information regarding trading activity than that provided to the consolidated feed; (2) physical placement, or co-location, of HFT firms' servers to the exchanges' servers; and (3) the exchanges' creation of complex order types such as "hide-and-light" orders that remain hidden from view until a certain stock price is reached, at which point the orders "light" and are executed before other investors waiting to trade.

Dark pool operations. Investors complained that the dark pool run by Barclays, it too being dependent on trading volume to produce revenue, used some of the same techniques to provide advantages to HFT firms, and misrepresented the practices to investors. The investors said the bank, knowing that these practices and the "predatory" HFT firms they attracted may drive off ordinary investors, advertised the dark pools as safe from high

frequency trading and created a service called "Liquidity Profiling," which rated firms as aggressive, neutral, or passive, and allowed firms to control who traded against it.

Jurisdiction. The court first rejected the argument that the comprehensive SEC regulatory scheme the exchanges were subject to meant that the case must be pursued through the SEC's administrative courts. The question presented by the investors was about whether the exchanges' activities violated Exchange Act Section 10(b), said the court, and therefore went to the merits of the claims, and not the court's authority to hear the case.

Immunity. The exchanges are SROs immune from private damage suits because they are performing regulatory functions that would in other circumstances be handled by the SEC, which is accorded sovereign immunity from all suits for money damages. Their status as for-profit corporations does not change the fact that as long as the exchanges' alleged misconduct falls within the scope of the quasi-governmental powers delegated to it, absolute immunity attaches, said the court. With the notable exception of co-location of servers, which the exchanges conceded serves no regulatory function, the practices criticized by the investors related to the exchanges' regulatory systems and thus enjoyed absolute immunity.

The complex order types pointed to by the plaintiffs were part of a framework by which buyers are matched with sellers, and by establishing this framework the exchanges define and police the way traders interact with each other, said the court, rejecting the investors' assertions that the order types were "products" created solely for business purposes. Even if the order types were born from a profit motive, where the act of creating a product has a regulatory dimension, the exchange is immune from suit based on that product, held the court. The court called the question of proprietary data feeds a closer question, but looking at the nature of the function performed, the court said it was not materially different than the feed provided pursuant to Regulation NMS, and was consistent with its quasi-governmental powers. Again, the court repeated, a profit motive is irrelevant.

Manipulation. The court then turned to claims under Exchange Act Section 10(b) for market manipulation and an Exchange Act Section 6(b) claim. Section 6(b) requires exchanges to adopt rules to prevent fraudulent and manipulative acts and to abide by those rules, but that claim was summarily dismissed because the court said 6(b) does not carry a private right of action.

Looking at the operations claimed to represent market manipulation, the court said none met the definition of a manipulative act; defined as one that defrauds investors by controlling or artificially affecting the price of securities. The investors did not plead that the exchanges failed to disclose the server co-location and proprietary data feed services, which were approved by the SEC, nor did they explain how "merely enabling a party to react more quickly to information can constitute a manipulative act, at least where the services at issue are publicly known and available to any customer willing to pay," said the court. More broadly, the operations did not represent primary violations but could only be construed as an aiding and abetting claims, which are barred by *Central Bank of Denver v. First Interstate Bank of Denver*.

Barclays. Looking at the claims asserted against Barclay, the non-SRO in the group, the court considered the same actions and found that the plaintiffs also failed to identify manipulative acts, nor did they establish reliance. An allegation that Barclays overrode the Liquidity Profiling rating of certain HFT firms did not explain how that action could have affected the price of a security trading in the bank's dark pool, said the court. The same went for allegations regarding co-location of servers and special access to the "logic of servers operating the dark pool," which investors said was used by HFT firms to refine their trading strategies. "Simply creating the background market conditions" for an alleged 10(b) violation is insufficient to state a 10(b) claim, the court concluded.

California claims. A claim under California law for the tort of concealment, based on the alleged concealment of aggressive HFT trading and recruitment of HFT firms was also dismissed, as were claims under California false advertising and unfair competition law. These claims, filed by Costa Mesa-based financial services firm Great Pacific Securities, were left standing by the court, however, because they could potentially be sufficiently pled in an amended complaint. These claims, said the court, were not based on an "inherently flawed legal theory." Great Pacific was given four weeks to file an amended complaint.

The case is No. 14-MD-2589 (JMF).

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Companies: City of Providence, Rhode Island; Plumbers and Pipefitters National Pension Fund; State-Boston Retirement System; Chicago Stock Exchange, Inc.; Direct Edge ECN, L.L.C.; The Nasdaq Stock Market L.L.C.; Nasdaq OMX BX, Inc.; New York Stock Exchange, L.L.C.; NYSE Arca, Inc.; Barclays PLC

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