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# High-Frequency Trading Cases Slow To Take Shape

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On Jan. 13, 2015, the U.S. Securities and Exchange Commission announced the formation of the 18-member Equity Market Structure Advisory Committee to address issues related to Regulation NMS (national marketing system), including the role of exchanges in the current market structure and conflicts in routing and execution of trades. One focus of the committee will be “the presence and effects of conflicts in the routing and execution of equity orders,” which is a euphemism for high-frequency trading (HFT) and its impact on market integrity.

This announcement provides an opportune time to assess the current state of enforcement and litigation related to HFT. A survey of the landscape shows continued attention from regulators and private plaintiffs and the emergence of several important themes, as well as the availability of significant defenses.

HFT burst into the public consciousness with the publication of Michael Lewis’ book “Flash Boys” in 2014. Loosely defined, HFT generally involves professional traders acting in a proprietary capacity and using some combination of extraordinarily high-speed, sophisticated programs for generating, routing and executing orders; co-location services and individual data feeds to minimize network and other latencies; establishing and liquidating positions within short time frames; the submission of multiple orders and their cancellation shortly thereafter; and efforts to end the day in a “flat” position (i.e., not holding large, unhedged positions overnight).

The SEC, other regulators, and private plaintiffs have expressed concerns that HFT gives its practitioners unfair advantages in the form of, among other things, inside information about order activity and the ability to front-run or otherwise manipulate trading in a manner that benefits themselves at the expense of other market participants.

HFT traders and others have countered that high-frequency traders provide low-cost trading options and liquidity by using lower-cost computers than the big trading houses and passing their savings on to investors. Those same market participants suggest that the presence of HFT causes prices to respond more quickly to trading and to generally reduce the ability of traders to buy or sell large volumes without affecting the market price, two outcomes generally acknowledged to be good for markets.

Thus far, enforcement and litigation has focused on the brokerages and trading firms engaged in HFT and the exchanges that enable it. As is often the case, the rush to respond to public discussion of HFT has led to an evolving set of legal theories and defenses.

**Key Private Litigation**

In one of the first private class actions brought against HFTs, a putative class of investors in City of Providence Rhode Island v. BATS Global Markets, 1:14-cv-02811 (S.D.N.Y. April 18, 2014) allege that certain exchanges, brokerages, alternative trading venues and high-frequency trading firms engaged in a variety of activities that constitute market manipulation under the federal securities laws, including Sections 6(b) and 10(b) of the Exchange Act. The amended complaint, though, dropped from the case the brokerage and HFT firms, leaving only several exchanges, Barclays PLC and Barclays Capital as defendants.

The plaintiffs in the City of Providence (and related cases now consolidated in the Southern District of New York) have alleged violations of several sections of the Securities Exchange Act and related rules:

- Section 10(b) and Rule 10b-5: the exchanges allegedly violated these provisions by providing HFTs preferred access — e.g., co-location access, enhanced data feeds, early access to bid information, and the ability to front-run bids — for a fee.

- Section 6(b): the exchange defendants allegedly operated their national security exchanges in an unfair, inequitable manner against the public interest, in violation of Section 6(b), which requires registered national securities exchanges to have rules designed to prevent fraudulent and manipulative acts and practices.

The defendants in City of Providence filed a motion to dismiss on the following grounds, among others:

- The district court lacks subject matter jurisdiction because the SEC has sole jurisdiction to review the plaintiffs' claims based on the exchange defendants' sale of co-location services and proprietary feeds.

- Registered national securities exchanges are immune from private damages suits when their activity "relates to the proper functioning of the regulatory system" and their conduct is "consistent with the exercise of power" delegated to the exchanges by the Exchange Act and, they argue in this case, in accordance with applicable SEC regulations.

- Individual plaintiffs lack standing to state a claim under Section 6(b) of the Exchange Act because there is no private right of action under that section.

- The plaintiffs fail to state a claim under Section 10(b) on the grounds that (1) selling co-location services and access to proprietary data feeds do not constitute misrepresentations; (2) plaintiffs cannot show actual reliance on any specific misrepresentation; (3) plaintiffs cannot show the exchange defendants acted with the required scienter, particularly given the SEC's statements that certain types of similar actions are "consistent" with the Exchange Act.

The motion to dismiss, filed in the consolidated cases on Jan. 23, 2015, is pending. Eventually, difficulty in calculating damages may also undermine a required element of the plaintiffs' Section 10(b) claim.

Another class action, Braman et al. v. The CME Group Inc. et al., 14-cv-02646 (N.D. Ill. April 11, 2014, which was filed in the Northern District of Illinois one week prior to City of Providence, alleges that two leading commodities exchanges, the Chicago Mercantile Exchange and the Chicago Board of Trad, violated the Commodities Exchange Act (CEA) by engaging in behavior similar to that alleged in City of Providence, i.e., charging HFTs for early access to nonpublic market data and allowing HFTs to execute trades prior to all other market participants.

They also argue that the defendants concealed their fraudulent practices by continuing to charge other market participants fees for "real-time data and price information." According to the plaintiffs, the defendants' manipulation of the price of financial futures contracts violated Sections 4c, 6c, and 22 of the CEA. In their second amended complaint, the Braman plaintiffs have also added claims for common law fraud and violation of Section 1 of the Sherman Antitrust Act.

The defendant's motion to dismiss, still pending before the court, states several grounds for dismissal:

- The plaintiffs lack individual standing to bring claims under any section of the CEA other than Section 22.

- The claim under CEA Section 9 fails because (1) the alleged actions do not constitute manipulation under the CEA; and (2) no false or misleading statements or facts were made "to the Commission."

- The claim under CEA Section 22 fails because (1) the complaint does not adequately allege the exchanges acted in bad faith and (2) the allegations do not show the required loss or loss causation. (According to the defendants, the fraud and antitrust claims also fail for similar reasons.)

In the more recently filed Lanier v. BATS Exchange Inc., 1:14-cv-03745-KBF (S.D.N.Y. May 23, 2014) case, a separate set of plaintiffs have filed another class action in the Southern District of New York against a set of exchanges. The plaintiffs — subscribers of market data provided by the exchanges — argue that the exchange defendants breached their contracts with the plaintiffs by selling advance access to market data to HFTs, depriving the plaintiffs of the benefit of their bargain for equal access to live market data. Based on these actions, the plaintiffs also have asserted a claim of unjust enrichment.

The motion to dismiss, currently pending, recapitulates many of the defenses in City of Providence, including challenges to jurisdiction, preemption by the Exchange Act and Regulation NMS, and absolute immunity. The defendants also argue that the plaintiffs' claims are barred by the Securities Litigation Uniform Standards Act, and that the allegations fail to plead several of the required elements for breach of contract.

Finally, private investors have filed several suits against Barclays and several Barclays executives, alleging that the defendants misled investors who traded in Barclays' dark pools by representing that they treat all dark-pool traders equally, but in fact gave preferential treatment and information to certain high-frequency traders. Great Pacific Securities et al. v. Barclays et al., 14-cv-1210 (C.D. Cal., July 31, 2014).

The complaint pleads state law claims of concealment and violation of California law against unfair competition and false advertising. By contrast, the plaintiffs in Strougo et al. v. Barclays PLC et al., 1:14-cv-05797 (S.D.N.Y., Dec. 15, 2014), contend that Barclays violated Section 10(b), Rule 10b-5, and Section 20(a) of the Exchange Act by failing to disclose material adverse information about the manner in which it operated its dark pools. Motions to dismiss in both cases are pending.

**Key Government Enforcement Matters**

The SEC has been actively scrutinizing HFTs and, in 2014, settled several matters. For example, the SEC filed a cease-and-desist order in April 2014 against a firm called Visionary Trading, among others, accusing the defendants of violating Exchange Act Sections 9(a)(2) and 10(b), as well as Rule 10b-5, by engaging in "spoofing," a practice in which a trader artificially manipulates the sale price of the security by placing and immediately canceling orders to create false impressions of buy or sell interest.

In October 2014, the SEC settled with Athena Capital Research LLC, an HFT firm. The SEC had charged Athena with violations of Section 10(b) and Rule 10b-5, asserting that Athena had employed algorithms to "mark the close" of publicly trading companies. The company's computer program allegedly searched for closing imbalances — discrepancies between the amount of buy and sell orders at closing — and then would immediately place both a large on-close order to fill the imbalance as well as orders on the opposite side of its own on-close order. This allegedly allowed Athena to artificially inflate or deflate prices in favor of its own on-close order.

The SEC also claimed that Athena willfully violated Section 10(b) and Rule 10b-5 by continuing to engage in these practices even after receiving an alert from Nasdaq that orders intended to manipulate the closing price would be reported to FINRA. As noted above, Athena did not admit or deny the SEC's findings.

More recently, the SEC filed suit, SEC v. Aleksandr Milrud, 2:15-cv-00237-KM-SCM (D.N.J. Jan. 13, 2015), against Aleksandr Milrud, for spoofing. According to the agency, Milrud's spoofing strategy violated Section 17 of the Securities Act, Sections 9(a)(2) and 10(b) of the Exchange Act, and Rule 10b-5. The SEC also maintains that Milrud was liable under Section 20(a) of the Exchange Act for any violations committed by the traders under his control. The U.S. Attorney's Office for the District of New Jersey has filed parallel criminal charges, SEC v. Aleksandr Milrud, 2:15-cv-00237-KM-SCM (D.N.J. Jan. 13, 2015). Thus far, only a complaint and summons have been issued in the SEC case. The criminal case is sealed.

The U.S. Commodity Futures Trading Commission is also actively investigating HFT practices for possible violations of the Commodities Exchange Act and/or CFTC rules and regulations. In 2013, the CFTC settled with Panther Energy Trading LLC and Michael Coscia regarding alleged spoofing. The CFTC order stated that Panther and Coscia violated Section 4c(a)(5)(C), 7 U.S.C. §6c(a)(5)(C), of the Commodities Exchange Act, which specifically prohibits spoofing — a provision added by the 2010 Dodd Frank Act.

And, for its part, the U.S. Department of Justice is also investigating whether HFT firms have violated insider trading laws. As part of its crackdown, federal prosecutors indicted Coscia on Oct. 1, 2014, United States v. Coscia, No. 1:14-cr-00551 (N.D. Ill. Oct. 1, 2014), for violating the anti-spoofing provision of the Commodity Exchange Act, and for commodity fraud in violation of 18 U.S.C. § 1348. On Dec. 15, 2014, Coscia moved to dismiss the charges, arguing that the anti-spoofing provision was void for vagueness and that the commodity fraud counts are “legally invalid.” The defendant’s motion is pending.

On the state enforcement side, the New York attorney general filed civil fraud charges in June 2014 against Barclays as part of the offensive against HFTs and “dark pools,” or private securities trading venues. In the lawsuit, New York’s top law enforcement officer asserts that Barclays misrepresented the number of HFT traders operating in Barclays’ dark pools and therefore failed to protect investors from predatory trading behavior. Barclays filed a motion to dismiss in July 2014, on the grounds that the complaint could not establish any actual harm, identifiable victims or material misrepresentations, and that the suit was preempted by the SEC’s right to oversee dark pools. The motion to dismiss is pending. In response, the attorney general has filed an amended complaint.

**A Long Road Ahead**

Notwithstanding the public furor over HFT and the resulting heightened interest on the part of regulators, private plaintiffs and other litigants, these cases show that there may be a mismatch between that concern and existing statutory and common law theories of liability. Private plaintiffs, in particular, appear to have struggled to identify HFT-related defendants against whom they can sustain claims. They likely also will face hurdles with respect to, among other things, class certification and the articulation of viable damages theories in the future.

Regulators and law enforcement agencies not dependent on private rights of action and, in at least some cases, not required to prove damages, may find the path ahead more welcoming, but they too could find that the targets of their actions have strong statutory and other defenses that will be a roadblock to this relatively new enforcement activity.

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