Morgan Lewis

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TRADING AND MARKETS ENFORCEMENT REPORT

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Trading and Markets Enforcement Report

The last several years have seen law enforcement and regulatory bodies sharpen their focus on trading activity in the securities and derivatives markets. This focus has coincided with the advent of new and expanded reporting, surveillance, and enforcement powers that arose from responses to the financial crisis. Prosecutors and regulators are using those powers daily to enforce both newer and longstanding restrictions on trading activity.

New developments and precedents emerge nearly every day, and the key events merit full attention in the design of trading strategies, the implementation of compliance programs, and—when necessary—the development of legal defenses. The following report serves as a practical guide intended to keep asset managers, broker-dealers, and other trading firms current on important legal developments in this area.

SIGNIFICANT REGULATORY DEVELOPMENTS

FINRA Issues Inaugural Round of Cross-Market Spoofing and Layering Report Cards

In late April, FINRA made available to its member firms the inaugural round of monthly cross-market equities supervision report cards focused on spoofing and layering. FINRA's report cards are designed to help firms track compliance with certain equity trading rules, such as trade reporting, best execution, and now, spoofing and layering. The recently issued report cards are specifically designed to help firms identify and halt spoofing and layering activity by summarizing such potential activity and related exceptions and trends during the prior six months. The report cards better enable firms to flag suspicious trading patterns by providing access to FINRA's "cross-market data" and advanced surveillance technology.

WHAT ARE SPOOFING AND LAYERING?

"Spoofing" is the practice of entering bids and offers with the intent to cancel them before they are executed, with the entry and cancellation usually occurring rapidly.

"Layering" refers to entering limit orders for the purpose of moving the market in order to obtain favorable execution on the other side of the market.

The spoofing and layering report cards are not made public; rather, they are sent to firms at which FINRA identifies potential spoofing or layering by the firms or entities provided with market access by the firms. FINRA has stated that the report cards do not represent findings that any violations have occurred. Nevertheless, firms should be on notice that FINRA will expect them to use the report cards to bolster surveillance in this area and take necessary action to prevent spoofing and layering. This is especially true if the report cards disclose potential problems at a firm. Firms that are not responsive to signs that they may be engaging in or facilitating spoofing and layering may find themselves in FINRA's crosshairs during future examinations or potential disciplinary actions. FINRA's latest initiative thus marks yet another

layer of scrutiny that firms are facing, as regulators attempt to root out spoofing and other deceptive trading practices.

FINRA Staff Keeps Focus on Manipulative Trading

Manipulative trading prevention was a key area of focus at the May 2016 FINRA annual conference. The conference highlighted new technology and cross-market surveillance that make it easier for regulators to detect illicit trading patterns, including spoofing and layering. This sophisticated technology will make it more difficult for firms to argue that potential manipulations are isolated incidents. As noted above, Jon Kroeper, the executive vice president of FINRA's market regulation department's quality of markets section, explained that FINRA has sent out—and will continue to send out—report cards to each firm detailing instances of suspected layering and spoofing. FINRA intends these written warnings to help firms detect and stop manipulative conduct, giving them the opportunity to correct violations early on, potentially before enforcement action is taken.

The head of FINRA's market regulation department's legal group, Robert Marchman, said FINRA will remain vigilant regarding compliance with Rule 15c3-5 of the Securities Exchange Act of 1934—the "Market Access Rule"—the purpose of which is to (1) ensure that firms do not give unauthorized traders access to the market and (2) require firms to monitor for manipulative conduct. Violators of Rule 15c3-5 may face seven-figure fines for insufficient controls to identify manipulative practices. According to Mr. Marchman, fines will be determined based on the specific facts and circumstances of each matter. Firms that self-report violations or provide FINRA with helpful information regarding the enforcement action may be eligible for smaller fines.

At the annual conference, discussion regarding FINRA's Trading and Financial Compliance Examination Program focused on trading algorithms. Against the backdrop of the SEC's approval of a new FINRA rule requiring algorithmic trading developers to register as securities traders, Peter Stoeher, the vice president of the program, discussed how FINRA will continue to monitor algorithms in order to determine whether adequate controls are in place. Possible controls include "kill switches" that can shut down algorithms if they malfunction or exceed trading limits.

BATS and NASDAQ Adopt Rules Prohibiting Spoofing and Layering

In February, Bats BZX Exchange, Inc. (BATS) received SEC approval of a proposed rule change to prohibit disruptive quoting and trading activity that constitutes spoofing or layering. Shortly thereafter, BATS' affiliated exchanges submitted "copycat" rule filings to implement the same proposed rule change. In June, the NASDAQ Stock Market LLC (NASDAQ) submitted a substantially similar proposed rule change.

While the new rules do not explicitly reference spoofing, "Disruptive Quoting and Trading Activity Type 1" includes a frequent pattern in which the following facts are present:

- a party enters multiple limit orders on one side of the market at various price levels (the Displayed Orders);

- following the entry of the Displayed Orders, the level of supply and demand for the security changes;
- the party enters one or more orders on the opposite side of the market of the Displayed Orders (the Contra-Side Orders) that are subsequently executed; and
- following the execution of the Contra-Side Orders, the party cancels the Displayed Orders.

Similarly, the new rules do not explicitly reference layering. However, "Disruptive Quoting and Trading Activity Type 2" includes a frequent pattern in which the following facts are present:

- a party narrows the spread for a security by placing an order inside the National Best Bid and Offer; and
- the party then submits an order on the opposite side of the market that executes against another market participant that joined the new inside market established by the order described above.

The exchanges also adopted separate rules designed to permit the exchanges to initiate expedited suspension proceedings for members found to be engaged in spoofing and layering. The new rules also give the exchanges the authority to order their members to cease and desist from providing access to the exchanges to the members' clients that are conducting disruptive quoting and trading activity.

The exchanges noted that the existing process of identifying disruptive and potentially manipulative activity and then bringing the matter to a final resolution often takes years—a lengthy period the exchanges believe is generally appropriate to guarantee members adequate due process, particularly when dealing with complex cases. However, the exchanges cited "certain obvious and uncomplicated cases of disruptive and manipulative behavior or cases where the potential harm to investors is so large that the Exchanges should have the authority to initiate an expedited suspension proceeding in order to stop the behavior from continuing on the Exchange[s]."

FINRA Amends Definition of "Securities Trader" to Include Developers of Algorithmic Trading Strategies

In early April, the SEC approved FINRA's proposed amendment to NASD Rule 1032 to require registration as a Securities Trader for any individual who is (1) primarily responsible for the design, development, or significant modification of an algorithmic trading strategy relating to equity, preferred, or convertible debt securities; or (2) responsible for the day-to-day supervision or direction of such activities. FINRA announced a January 30, 2017 effective date in early June in Regulatory Notice 16-21, which also included additional insight into the implications of this change.

An "algorithmic trading strategy" is a trading strategy programmed into an automated system that generates or routes orders (or order-related messages) following a defined set of

instructions at a speed and frequency no human trader could complete. FINRA's view is that the newly required registration will increase the scope of trading information FINRA receives, provide market participants and investors with greater visibility into trading activities, and require employees at firms engaged in electronic trading to be trained, educated, and accountable for their role in algorithmic trading strategies. Covered individuals must pass the Securities Trader qualification examination (the Series 57 Exam) prior to registration.

The new registration requirement will bring algorithmic developers within FINRA's jurisdiction for the first time. This change will have several practical implications for firms and their personnel, including in the following areas:

- Requirements for principal supervision of Securities Traders, which could mandate that additional personnel become licensed and registered as principals.
- Enhancements to supervisory procedures and compliance monitoring.
- Development of additional continuing education training and incorporation into firms' CE programs.
- Increased expenses relating to the items above, as well as additional fees and expenses relating to qualification examinations, registration fees, and, generally, additional staff to comply with requirements.

FINRA Reduces Clock Sync Tolerance

In April, the SEC approved FINRA's proposal to reduce, from one second to 50 milliseconds, the synchronization tolerance for computer clocks used to record events in NMS securities and OTC equity securities. Business clocks currently must be synchronized to within one second of the National Institute of Standards and Technology (NIST) atomic clock. In approving the change, the SEC noted the significance of the clock sync standard and its importance in improving transparency and enhancing regulators' surveillance and enforcement capabilities. The tighter clock sync standard will be used by the SEC and FINRA to reconstruct trading patterns with greater accuracy and more easily detect potentially fraudulent and manipulative activity, including spoofing and layering. Broker-dealers must comply with the reduced 50-millisecond sync tolerance beginning on February 20, 2017 for clock systems that currently capture time in milliseconds, and on February 19, 2018 for other clock systems.

RECENT GOVERNMENT LITIGATION & ENFORCEMENT ACTIVITY

Nation's First Convicted Spoofer Sentenced to Prison

Marking another legal milestone, on July 13, Michael Coscia became the first individual sentenced to prison for spoofing. US District Judge Harry D. Leinenweber for the Northern District of Illinois sentenced the embattled founder of Panther Energy Trading LLC to three years' imprisonment following his conviction for spoofing and commodities fraud. The sentence comes on top of the $4.5 million fine that Mr. Coscia has already paid to regulators. Mr. Coscia has vowed to appeal his conviction to the US Court of Appeals for the Seventh Circuit and asked Judge Leinenweber to grant him bail while his challenge is pending.

Mr. Coscia was accused by the government of utilizing sophisticated computer trading algorithms called "Flash Trader" and "Quote Trader" to manipulate futures market prices. The Flash Trader algorithm allegedly placed a small order on one side of the market, and the Quote Trader algorithm would place large orders on the opposite side simultaneously. The large orders were then promptly canceled just before execution, creating the illusion of market interest, or disinterest, in different commodities to artificially move prices in Mr. Coscia's favor. Only after the market reacted to these orders did Mr. Coscia allegedly place and fill "real" orders, purportedly reaping $1.4 million in profits. Mr. Coscia's lawyers, however, maintained throughout the case that his activities were consistent with routine trading behavior, arguing that the number of large orders he *filled* was five times higher than that of an average trader.

In November 2015, after a six-day trial, a federal jury found Mr. Coscia guilty of six counts of commodities fraud and six counts of spoofing—a verdict particularly significant because the spoofing statute is arguably amorphous in its meaning and technical in its application.

On April 6, 2016, Judge Leinenweber denied Mr. Coscia's motion for a new trial. The court rejected Mr. Coscia's challenge to the sufficiency of the evidence, as well as his argument that the spoofing charges were unconstitutionally vague—contending that the charges covered lawful activity—because of the weight of the evidence and Mr. Coscia's intent to cancel the orders. And the court rejected Mr. Coscia's challenge to the jury instructions. (Mr. Coscia's earlier motion to dismiss the charges against him was also denied: Judge Leinenweber concluded that Congress's prohibition on spoofing was presumptively valid, and that Dodd-Frank fairly apprised Mr. Coscia that his specific trading activities were illegal.)

Mr. Coscia's prosecution may be a harbinger of things to come. The US Department of Justice (DOJ) and other government and quasi-government entities have stepped up their enforcement of spoofing activities and have made public statements to this effect.

Dark Pool Crackdown Is the Beginning, Not the End

State and federal regulators have planted the proverbial stake in the ground, signaling that there is more to come following a recent crackdown on "dark pools."

WHAT IS A DARK POOL?

A "dark pool" is a trading system that enables the execution of trades without any prior display of specific order information.

Over the last two years, the SEC settled several enforcement cases against numerous financial services firms, totaling $189 million. Dating back even longer to 2014, a financial services firm settled a case based on its LavaFlow alternative trading system, which, allegedly, similarly exploited information about hidden customer orders to trade through smart-order routers that continuously search for the optimal execution method. These actions merely represent the tip of the spear, according to regulators. SEC Chairwoman Mary Jo White stressed, "I think you'll see more dark pool cases" and "the SEC will continue to shed light on dark pools to better protect investors." Echoing Chairwoman White's message, SEC Director of Enforcement Andrew Ceresney and New York State Attorney General Eric Schneiderman confirmed that other investigations were continuing. Mr. Schneiderman warned, "[W]e will continue to take the fight to those who aim to rig the system and those who look the other way." Mr. Ceresney added that "[t]his is an area where both of our institutions are focused."

Federal Prosecutors Flex Their Muscles Abroad in Spoofing Clampdown

In March, a UK court approved a request by US authorities to extradite a British national, Navinder Singh, accused of a sprawling market manipulation scheme—including activities purportedly responsible for the 2010 "flash crash." Mr. Singh faces civil claims and criminal charges in the United States based on his alleged use of an altered computerized trading program. Using sophisticated algorithmic software, Mr. Singh allegedly placed—then promptly canceled—thousands of trades to reap $40 million in profits between 2009 and 2014. Mr. Singh's alleged spoofing conduct, the UK court concluded, would likely be illegal in the United Kingdom, too, thus satisfying the so-called "dual criminality" requirement for extradition. The UK court's decision, however, does not guarantee Mr. Singh's extradition: the decision is subject to appeal, and the UK Secretary of State must still approve the extradition agreement.

Mr. Singh's extradition reflects the lengths to which federal regulators are going to police spoofing. His prosecution also sends a powerful message to algorithmic traders, here and abroad, that geographic boundaries will not guarantee immunity.

Traders Get Heavy Fines for Gold, Silver, and Gas Spoofing

In April, three traders—UAE-based Heet Khara and Nasim Salim, and David Kotz—settled disciplinary actions by units of the CME Group and New York Mercantile Exchange alleging that they spoofed the futures markets in gold, silver, and natural gas. The trio will pay combined fees of $390,000. Messrs. Khara and Salim were ordered to pay $90,000 and $100,000, respectively, and both were permanently banned from seeking membership at any CME Group Exchange or accessing any trading platform or floor owned by the group. Mr. Kotz will pay a larger fine of $200,000, but receive only a 15-day suspension. All three settled without admitting or denying any allegations.

Messrs. Khara and Salim have also faced fire from federal regulators. Last May, the CFTC sued them in federal court, alleging that they manipulated the market for gold and silver futures by placing large aggregate orders for contracts on the COMEX opposite smaller orders, then canceling the bulky orders after the opposing ones cleared. And Mr. Khara allegedly continued to engage in disruptive trading practices—even as the CME Group warned him it was

investigating his conduct. Following settlement with CFTC, Messrs. Khara and Salim were ordered to pay $1.38 million and $1.31 million, respectively, and both were permanently barred from trading commodities or acting as principals or agents for any firm overseen by the CFTC.

The hefty fines imposed by CFTC, CME Group, and the New York Mercantile Exchange confirm that regulators' sights remain trained on spoofing activity, and that trading abroad will not escape scrutiny.

Judge Imposes Limited Constraints on Alleged Spoofer Igor Oystacher and His Firm, 3Red Trading, LLC

Rebuffing regulators, a federal judge agreed to impose only modest restraints on the trading activities of accused spoofer Igor Oystacher, the CEO and founder of 3Red Trading, LLC, pending the outcome of his trial, scheduled for January 2017. Significantly broader curbs proposed by regulators were rejected by the court.

The CFTC had sued Mr. Oystacher and his firm in federal court in Chicago in October 2015, alleging that since 2011 he had manipulated futures pricing through spoofing by placing thousands of large orders on one side of the buy-sell spectrum, only promptly to cancel them and place small trades on the other side of the spectrum. Mr. Oystacher's activities—including 1,316 alleged "spoofing incidents"—reportedly cost other market participants millions of dollars in just a few months' time. Mr. Oystacher insists that his alleged trading practices are common among market participants: Mr. Oystacher's lawyers have argued that orders are canceled 90% to 95% of the time, and that even canceling orders within one second of placement happens in 50% of orders.

After the suit was filed, the CFTC upped the ante by asking US District Court Judge Amy St. Eve to sign off on a preliminary injunction that would keep Mr. Oystacher on the sidelines from trading while his case is pending. The injunction sought would have had far-reaching effects: It would have barred Mr. Oystacher from trading S&P E-mini futures on the Chicago Mercantile Exchange; volatility index futures on the CBOE Futures Exchange; copper on the COMEX; and crude oil and natural gas futures on the NYMEX. At the hearing on the CFTC's preliminary injunction motion, Mr. Oystacher admitted that he has been investigated by, and even received warnings from, regulators from every exchange on which he has traded, and that he previously paid a fine of $150,000 pursuant to a settlement reached with the Chicago Mercantile Exchange.

Nonetheless, Judge St. Eve, in a lengthy decision entered on July 12, rebuffed the CFTC by refusing to bar Mr. Oystacher from trading. Instead, Judge St. Eve ordered Mr. Oystacher and his firm to maintain certain compliance tools and submit certain trading surveillance reports, including a mandatory monthly attestation made by the firm's Chief Compliance Officer. The court also limited Mr. Oystacher's trading to the two markets in which he currently trades—the E-Mini S&P 500 futures market and a 10-year Treasury-note futures market.

If Mr. Oystacher's counsel is correct that his activities are "overwhelmingly the norm," his legal fate could have ramifications for other market participants as well. Finally, Mr. Oystacher's

lawyers have launched a broadside on the law itself, contending that the anti-spoofing provision in the Commodity Exchange Act is void for vagueness. That motion remains pending.

Supreme Court Denies Cert in SEC Market-Rigging Action

In late March 2016, the US Supreme Court denied certiorari in *Koch v. SEC*, marking a victory for securities regulators. Donald L. Koch had sought review of allegations that he had rigged stock prices to boost client accounts. The high court's decision means that the DC Circuit's July 15, 2015 decision against him stands.

Mr. Koch had argued that he was not a "primary violator" of the securities laws under the Supreme Court's decision in *Janus Capital Group v. First Derivative Traders*, but the three-judge panel of the DC Circuit was unconvinced. The court had determined that Mr. Koch had "marked the close," a practice targeted by regulators because it can artificially inflate stock prices. The SEC in this case had demonstrated that Mr. Koch purchased large quantities of stock in multiple venues before the daily close in order to produce favorable shifts in prices.

However, the SEC will not be able to impose the more rigorous penalties available under the 2010 Dodd-Frank Act, including a ban from association with any SEC-regulated entity. The DC Circuit Court had rejected retroactive application of the statute, stating that Congress did not intend for it to apply retroactively in the circumstances presented in Mr. Koch's case. Judge Karen LeCraft Henderson had ruled that additional prohibitions would be "impermissibly retroactive" because they would unfairly ban Mr. Koch from associating with a credit rating agency or municipal adviser in connection with conduct predating passage of the Dodd-Frank Act.

KEY PRIVATE LITIGATION

ISDAFix Class Action Update

At the end of March, a Manhattan federal judge denied a motion to dismiss by a number of defendant banks, allowing a class action alleging manipulation of International Swaps and Derivatives Association (ISDA) rates to proceed. Judge Jesse M. Furman of the Southern District of New York found that the plaintiffs had sufficiently stated a claim that the defendant banks had violated antitrust laws by conspiring to manipulate ISDAfix rates (a common reference rate for fixed-interest-rate swap rates). In May, several of the named banks agreed to pay a settlement in the amount of $324 million. Claims remain outstanding against certain non-settling parties.

The plaintiffs claim that the banks "banged the close" and fixed the ISDAfix rates by buying and selling derivative products just before closing to move prices in their favor. According to Judge Furman, benchmark manipulations are "economically sensible" and allow banks to maximize profits, but price fixing is the type of anticompetitive behavior that the antitrust laws are designed to cure. Judge Furman also noted similarities between the alleged ISDAfix rigging and

the London Interbank Offer Rate manipulation cases from 2015. The court rejected the banks' argument that they did not restrict supply and thus did not create an artificial restraint of trade.

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