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Client Alert

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SEC Announces First-Ever Market Manipulation Case Against High-Frequency Trading Firm

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On October 16, 2014, the US Securities and Exchange Commission (SEC) announced a settlement in the amount of US$1 million with Athena Capital Research LLC to resolve claims of market manipulation involving Athena's use of complex trading algorithms to manipulate the closing prices of thousands of stocks by flooding the market with massive numbers of buy or sell orders during the final seconds of the trading day, a manipulative practice typically known as "banging the close."[1] This action represents the first-ever market manipulation case brought by the agency against a high-frequency trading ("HFT") firm.[2]

Although Athena neither admitted nor denied liability, the charges reflect an increase in regulatory scrutiny of HFT activities as well as an acknowledgment by the SEC that HFT strategies can be employed to execute trading schemes traditionally considered manipulative. The lapse in time between the occurrence of the offending conduct and the agency's prosecution of the offender, however, also raises questions as to the level of priority given HFT in the SEC's enforcement agenda and how well-equipped the agency is to uncover and prosecute manipulative HFT conduct. One fact made clear by this action, nonetheless, is that closer scrutiny of HFT by SEC and additional enforcement actions directed towards HFT activities are likely to follow.

Athena Capital's Challenged Trading Strategy: "Gravy"

Athena Capital is a New York City–based HFT firm that utilizes algorithmic trading strategies to manage approximately US$40 million in assets. According to the SEC's cease-and-desist order (the "Order"), between June and December 2009, Athena executed massive volumes of rapid-fire trades in the last two seconds before Nasdaq's 4:00 p.m. close in order to drive the stocks' closing prices slightly higher or lower, thus ensuring more reliable profits.[3]

1 Securities and Exchange Commission, *SEC Charges New York Based High Frequency Trading Firm with Fraudulent Trading to Manipulate Closing Prices*, Press Release, Oct. 16, 2014.

2 "High-frequency trading" or "HFT" refers to algorithmic trading strategies that utilize sophisticated technologies and high-speed data connections to move in and out of equity positions within fractions of a second. Previously the province of a few specialized and unregulated proprietary trading firms, HFT has expanded alongside innovations in information and communications technology, and now accounts for a significant percentage of average daily trading in US equities markets. Nathaniel Popper, *High-Speed Trading No Longer Hurtling Forward*, NEW YORK TIMES, Oct. 14, 2012 and *Declining US High Frequency Trading*, NEW YORK TIMES, Oct. 14, 2012.

3 *In the Matter of Athena Capital Research, LLC*, Order Instituting Administrative and Cease-and-Desist Proceedings, pursuant to Section 21C of the Securities Exchange Act of 1934 and Section 203(e) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, File No. 3-16199 (Oct. 16, 2014).

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The Order alleges that Athena's manipulation focused on trading in securities that were likely to have "order imbalances," which occur when there is insufficient demand to match buy and sell offers for a given stock at the close of the day's trading. In these situations, Nasdaq conducts a "closing auction" to fill the imbalance, setting the price for such auction at a price nearest to the last trade on the "continuous book", i.e., those trades that occur just before the market close, in order to reduce volatility in the stock. Ten minutes before the close, Nasdaq begins sending out "imbalance messages" advising the market of those stocks likely to experience an end-of-day imbalance in order to facilitate filling as many "on-close" orders as possible at the best price.

The SEC contends that, when Nasdaq sent out its imbalance messages to market participants, Athena's trading algorithms would submit on-close orders matching the imbalances, which would only be filled if the identified imbalance remained as of the close. Then, using a sophisticated set of "high-powered computers, complex algorithms and rapid-fire trades" dubbed "Gravy," Athena would acquire securities or short positions on the opposite side of its imbalance-only on-close order, including submitting large numbers of orders in the seconds and milliseconds immediately preceding the close. This fevered trading activity in the waning seconds of the trading day often materially impacted the closing price of the security involved, thus insuring a better price—and higher profit—for Athena when its imbalance-only on-close order was filled in the subsequent closing auction. Such a scheme is typically known as "banging the close" and has been prosecuted as manipulative in the past—though not previously against an HFT firm.

Over time, Athena refined its trading strategies and algorithms to ensure that its trades took priority over competing orders, ultimately making up over 70 percent of the total Nasdaq trading volume of the affected stocks in the two seconds before the close of almost every trading day during the affected time period. Athena's "Gravy" strategy, the SEC claims, enabled the firm to manipulate closing auction prices employed by Nasdaq for tens of thousands of stocks over the relevant time period.

Traditional Notions of Manipulative Trading Behavior

The Order states that Athena willfully violated Section 10(b) of the Exchange Act and Rule 10b-5 thereof. Section 10(b) of the Securities Exchange Act and Rule 10b-5 prohibit the use of a "manipulative or deceptive device or contrivance" in connection with the purchase or sale of securities.[4] The Supreme Court has defined market manipulation as those "practices that are intended to mislead investors by artificially affecting market activity."[5] In the Second Circuit, manipulation violates Section 10(b) when a "false pricing signal," i.e., an artificial or phony price of a security, is communicated to the persons who, in reliance upon a misrepresentation that the price was set by the market forces, purchase the securities. *ATSI Comm'ns v. Shaar Fund, Ltd.*, 493 F.3d 97, 100 (2d Cir. 2007). Manipulation claims must state with particularity the nature, purpose and effect of the fraudulent conduct as well as the specific roles in the fraud played by each defendant. *Id.* at 101.

The Order alleges that, as a result of its illegal conduct, Athena was able to execute its imbalance-only on-close trades at more favorable prices, at the expense of increased market volatility and price distortion. The SEC also cites numerous internal Athena emails to show that the HFT firm acted knowingly and intended to impact closing stock prices through its manipulative trading activity.

Implications

The SEC's action against Athena raises a number of questions concerning how regulatory agencies will react to traditionally manipulative schemes when employed by high-frequency traders, particularly, in light of increased public attention on HFT. The SEC has already indicated that it is pursuing "a number of other investigations" of algorithmic trading firms for suspected manipulative activity.[6] In addition, a number of other state and federal regulators, including the CFTC, FINRA, Department of Justice, the FBI and the New York State Attorney General's office, have also announced investigations into HFT practices or commenced litigation against HFT firms and industry participants. These legal and regulatory activities also raise a question regarding how well-equipped regulators currently are to police HFT activities aimed at implementing trading strategies traditionally thought of as manipulative.

4 15 U.S.C. § 78j(b). Further, Rule 10b-5 also makes it unlawful: "(a) to employ any device, scheme, or artifice to defraud," or "(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

5 *Santa Fe Indus v. Green*, 430 US 462, 476-77 (1977); *see also Gurary v. Winehouse*, 190 F.3d 37, 45 (2d Cir.1999) ("The gravamen of manipulation is deception of investors into believing that prices at which they purchase and sell securities are determined by the natural interplay of supply and demand, not rigged by manipulators.")

6 Bradley Hope & Scott Patterson, *High-Frequency Trader Athena Capital Settles Stock-Manipulation Charges*, WALL STREET JOURNAL, Oct. 16, 2014.

The fact that the challenged conduct in the Athena Capital matter occurred more than five years prior to the SEC bringing these claims signals one of two things (and perhaps both): (i) the massive amount of trading data generated by HFT significantly slows down the pace of regulatory oversight, potentially leading to a tremendous backlog in enforcement actions aimed at even run-of-the-mill market manipulation by HFT traders; and/or (ii) the SEC is only now, in light of the increased public scrutiny of HFT and HFT trading firms, turning its attention to the activities of these previously little-known market actors. In either case, the Athena Capital action portends greater scrutiny of HFT activities by SEC and other governmental regulators, likely leading to additional enforcement actions against HFT traders who use such techniques to engage in manipulative conduct.

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