To Our Clients and Friends

Memorandum

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In re: Barclays Liquidity Cross and High Frequency Trading Litigation: A Review of the Litigation and Enforcement Landscape Surrounding High Frequency Trading

Last week, a federal district court judge in New York overseeing several multidistrict litigation ("MDL") proceedings dismissed all claims against Barclays PLC, Barclays Capital Inc., and several major U.S. stock exchanges (the "Exchanges"), including NASDAQ, the New York Stock Exchange, BATS Global Markets, and the Chicago Stock Exchange, brought by pension funds and other investors accusing the Exchanges of manipulation and other market abuse in connection with high frequency trading ("HFT"). This alert briefly analyses the court's decision in *In re: Barclays Liquidity Cross and High Frequency Trading Litigation* and other recent legal developments relating to HFT in the U.S. and E.U.[1]

The U.S. District Court Decision

The plaintiffs in *In re: Barclays* asserted both federal and state law claims against the Exchanges, accusing them of engaging in a "*manipulative scheme*" prohibited under Section 10(b) of the Exchange Act and Rule 10b-5's accompanying antifraud prohibitions. The plaintiffs also asserted several state law false advertising and unfair competition claims, as well as claims under Section 6(b) of the Exchange Act, which requires the Exchanges to adopt and follow rules and regulations designed to "*prevent fraudulent and manipulative acts and practices."* 15 U.S.C. § 78f(b). The plaintiffs' claims relied principally on allegations that the Exchanges facilitated manipulative HFT by other market participants, providing HFT firms with the "*ingredients*" necessary for complex trading strategies that the plaintiffs alleged exploited ordinary investors.

More specifically, the plaintiffs alleged that the Exchanges had rigged their markets in favour of HFT firms, incentivised by a desire to maximise trading activity and the accompanying commission revenue flowing from executed trades. The plaintiffs' allegations centered on market data arbitrage, whereby HFT firms seek to use high-speed trading strategies to take advantage of newly-released information before other market participants can react. With respect to the Exchanges, the plaintiffs focused on three basic features of the Exchanges' operations:

[1] The court's ruling in *In re: Barclays Liquidity Cross and High Frequency Trading Litigation*, Case No. 14-md-02589 (S.D.N.Y. Aug. 26, 2015), may be found here.

1. *Proprietary data feeds*: The Exchanges' provision of enhanced data feeds providing detailed information regarding trading activity directly to the proprietary feed's subscribers.

2. *Co-location*: Installing HFT firm servers extremely close to the Exchanges' own servers, thereby minimising the time taken for a HFT firm's server to interact with the Exchanges' servers.

3. *Complex order types*: The creation of pre-programmed commands to instruct Exchanges in how to handle HFT firms' orders based upon different scenarios, thereby allowing programmatic trades to be executed more rapidly.

The court granted the defendants' motions to dismiss in their entirety, holding that the Exchanges are "*absolutely immune from suit based on their creation of complex order types and provision of proprietary data feeds, both of which fall within the scope of the quasi-governmental powers delegated to the Exchanges.*" The court also went on to consider whether the above operations supported market manipulation claims, even in the absence of Self-Regulatory Organisation ("SRO") immunity, holding that the Exchanges' provision of co-location services and proprietary data feeds "*does not qualify as manipulative.*" The court emphasised that the plaintiffs had failed to explain how merely enabling HFT firms to execute their transactions or react more quickly to existing trading information could constitute a manipulative act when "*the services at issue are publicly known and available to any customer willing to pay.*"

Significantly, the court concluded that any market impact was caused by the HFT firms themselves, and not by the Exchanges. The court underscored that merely facilitating trades by a HFT firm that separately commits a manipulative or deceptive act was not sufficient to establish legal liability.

Commentary

The *In re: Barclays* decision underscores the clear limits of private securities litigation as a mechanism for addressing larger debates over market structure and HFT trading. HFT is not clearly defined in U.S. or E.U. securities law or regulations. The term generally refers to the practice of using computer-driven algorithms to rapidly move in and out of share positions, generating profit by arbitraging small differences in share prices, often across different exchanges. Critics of HFT argue that it serves no productive purpose and merely allows traders to exploit technological market inefficiencies at the expense of less sophisticated market participants. Its defenders argue that HFT increases market liquidity, reduces volatility, minimises transaction costs, and enables quicker price discovery by narrowing the bid-ask spread. It is estimated that HFT now accounts for approximately half of all trading volume in U.S. and E.U. markets.

It is beyond doubt that HFT is controversial and has drawn significant attention from securities regulators and law enforcement authorities. The SEC and other regulators have expressed concern that HFT can give traders an unfair advantage and disrupt orderly trading. The principal concerns expressed are twofold. First, regulators have expressed concern that the algorithms employed in HFT can jeopardise market integrity when they malfunction. By way of example, the May 2010 "*Flash Crash*" was reported to have been caused by HFT algorithms triggering an unprecedented sell-off of S&P 500 futures contracts in response to a falling market, erasing over one trillion dollars in overall market value. Second, HFT enables traders to more readily execute aggressive trading strategies that can facilitate market abuse.

Some of the more common HFT techniques singled out for regulatory criticism include:

1. *Spoofing/Layering*: Placing a series of orders and then withdrawing them before execution in order to create the impression of demand and artificially inflate the price of securities.

2. *Quote Stuffing*: Quickly entering and withdrawing large orders in an attempt to flood the market with quotes that competitors must process, causing them to lose their competitive edge.

3. *Pinging*: Seeking to discover the presence of large "*iceberged*" orders by sending small buy and sell orders, which if fulfilled can enable interception of a larger order.

4. *Momentum Ignition:* Attempting to trigger a number of other participants to trade quickly, thereby causing a rapid price move that benefits existing positions or other trades.

While U.S. regulators have been active in their enforcement efforts against such practices, E.U. regulators have lagged behind their counterparts. In the U.K., the recent Final Decision Notice issued by the FCA against high frequency trader Michael Coscia for market abuse under s.118 Financial Services and Markets Act 2000 in the form of "*layering*" represents a notable exception. However, change is afoot in the litigation and enforcement landscape surrounding HFT. The Markets in Financial Instruments Directive II (2014/65/EU) ("MiFID II") and the Markets in Financial Instruments Regulation (Regulation (EU) No. 600/2014) ("MiFIR") will for the first time directly regulate HFT, requiring the implementation of effective risk controls, together with additional HFT notification and transparency requirements.

The *In re: Barclays* decision is not novel or groundbreaking, and reflects the reality that the Exchanges cannot be held vicariously liable for trading by non-party HFT firms. Arguably, the plaintiffs' claims were also misdirected at market data arbitrage, as opposed to other aspects of trading activity. However, regulators, policymakers, and law enforcement officials are paying close attention to the ways in which speed and HFT complexity may facilitate market abuse. Coupled with increased regulatory oversight and surveillance, including under the E.U.'s MiFID and MiFIR, HFT firms will continue to find themselves the subject of considerable legal scrutiny.

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