Keeping the Market Safe: Where Whistleblowers Come In

Picture the stereotypical Wild West duel – high noon, town square, two sides. *Sheriff v. Outlaw*. While John Wayne and classic Westerns may have overplayed this iconic American scene, a modern equivalent is more prevalent than you think.

Like their Wild West counterparts, market spoofers are always trying to stay one town ahead of the sheriff, and sometimes they succeed… for a while.

The problem is that today's market doesn't exist in the realm of one-bullet revolvers, covered wagons and the Pony Express; it exists in a fast-moving and rapid-fire state of constant change thanks to computerized trading and our technology-driven environment.

Technology has always had a tremendous and unexpected effect on the stock market, and while those effects have benefitted investors in many ways, there also exist new methods for market manipulators to dodge the law, creating shockwaves of volatility for unknowing investors. But as spoofers have gotten savvy, so have their whistleblower counterparts.

The modern-day Billy the Kid does have some tricks up his sleeve, like spoofing – intentionally placing a large order that you do not intend to trade in order to trick others into thinking the market is going that way and to trade accordingly; or layering, placing several orders a few ticks apart to convey a buy or sell interest.

In these forms of manipulative, high-speed trading and high-frequency trading (HFT), the trader places non-bona fide orders to buy or sell securities and then quickly cancels them before they are executed. These non-bona fide orders artificially move the price of security up (in the case of non-bona fide buy orders) or down (in the case of non-bona fide sell orders) and induce other market participants to buy or sell a security at a price not representative of actual supply or demand.

And what's worse – unlike the face-to-face duels of the Wild West, these gunslingers are hiding in what our whistleblower client, Haim Bodek, famously calls "dark pools" within the market, alternative trading systems where price and size of the order isn't visible.

Who can take down the essentially invisible fraudsters within the market? Who better than a trader who was spawned from Wall Street itself?

Haim worked as a Wall Street insider at Goldman Sachs and UBS, then launched his own high-speed trading firm. In the height of HFT, he realized something – a corrupt insiders' game that rigged the system for the speed traders.

Haim worked for years to uncover a sneaky form of market manipulation that essentially allowed speed traders to jump in line through "Hide not Slide" order types, leaving regular investors with a knife at the gun fight.

In Haim's whistleblower case, brought by Hagens Berman, he revealed to regulators the underlying agreement – Direct Edge (which merged with BATS) offered an order type that went against basic market principles that stipulate that stock exchanges honor the best-priced buy and sell orders, despite the exchange they were placed on, in the order they were entered. Hide Not Slide orders were hidden, allowing them to slip in ahead of some one-day limit orders that had been entered earlier, violating the Securities Exchange Act of 1934.

This year, after Haim solidified his findings and prepared a whistleblower case to the SEC with our firm, his information led to the biggest fine ever levied against an exchange – $14 million.

In another recent whistleblower case our firm brought to the government's attention, both the U.S. Commodity Futures Trading Commission (CFTC) and the Department of Justice, in separate criminal and civil enforcement actions, brought charges of market manipulation and spoofing against Nav Sarao Futures Limited PLC and Navinder Singh Sarao for fraud that contributed to the Flash Crash on May 6, 2010.

The whistleblower – who will remain anonymous until the case is finalized – brought his concerns and original analysis to the CFTC after hundreds of hours analyzing data on the trader's massive disruption and canceling of orders without transactions.

The fraudster's trades pushed more than $200 million worth of persistent downward pressure on the E-mini S&P, and the defendant used the layering algorithm on more than 400 trading days, racking up a profit of more than $40 million from the fraud… until the law caught up with him.

Proponents will say that if you're not smart enough to know you're getting spoofed, that's the luck of the draw, but spoofing harms everyone by creating a volatile market. Like the Lone Ranger needed Silver, the market needs whistleblowers.

Dodd-Frank's regulations serve to protect all market participants, and spoofers should be careful because regulators aren't the only ones watching – the vigilantes are out there as well.

Whistleblowers continue to make headlines in the financial services world. Last year, whistleblowers received $435 million in payouts, and last September, the SEC paid more than $30 million to one tipster alone—a record award for the agency.

The whistleblower phenomenon has only gained momentum in 2015. Last month, the SEC announced a payment of more than $1 million to a whistleblower with an internal audit or compliance responsibility, and in April, the SEC announced a first-ever whistleblower award in a retaliation case.

SEC Chairwoman Mary Jo White called the SEC whistleblower program a success, hailing whistleblowers for providing an invaluable public service and positioning the SEC as the whistleblower's advocate.

Whistleblowers are often the best mechanism by which the SEC can learn about these forms of manipulation. Fettering out fraud is a public service in this fragile market, and whistleblowers are the modern-day vigilantes of the Wild West, helping the government to sniff out wrongdoing and ringing the alarm to help protect investors.

Today, the West may not be so wild, and outlaws may be able to lurk in the dark pools, but as John Wayne's character told his faithful sidekick in *Chisum* (1970), "No matter where people go, sooner or later there's the law."