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***Investigations, Enforcement and White Collar***

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# The SEC Sends a Stern Reminder That It Is Serious About Punishing "Spoofing" and "Layering" Schemes in the Securities Markets

***By Clifford C. Histed and Gilbert A. Perales***

On March 10, 2017, the U.S. Securities and Exchange Commission ("SEC") filed a civil complaint in the U.S. District Court for the Southern District of New York alleging that a Ukraine-based trading firm committed securities fraud by manipulating the U.S. securities markets hundreds of thousands of times with the alleged help of a New York-based brokerage firm and its owner.[1] Specifically, the SEC alleges that Avalon FA Ltd ("Avalon") made more than $28 million in illicit profits by employing two manipulative trading schemes—"layering" and "cross-market manipulation".[2] The SEC further alleges that Avalon's owner, Nathan Fayyer, and Sergey Pustelnik, who allegedly held an undisclosed, controlling interest in Avalon and embedded himself at Lek Securities Corporation ("Lek Corp.") as a registered representative, directly facilitated the manipulative schemes, and that Lek Corp. and its owner Samuel Lek made the schemes possible by providing Avalon access to the U.S. securities markets.[3]

While the complaint charges the defendants with perpetrating, participating in, or assisting in two types of securities fraud, we focus here on the layering allegation. With the advent of algorithmic, high-frequency trading in the securities markets, new forms of manipulative trading strategies—like layering, which is a specific form of "spoofing"—have emerged.[4] Nevertheless, U.S. securities regulators have been investigating and prosecuting alleged spoofing in the securities markets under the anti-fraud provisions of both the Securities Act of 1933 and the Exchange Act of 1934, and SEC Rule 10-b5, since at least the early 2000s.[5] More recently, in 2015 the SEC charged Aleksandr Milrud with orchestrating a manipulative trading scheme carried out through spoofing and layering.[6] Therefore, the Lek and Milrud cases serve as stern reminders that the SEC remains vigilant and aggressive when it comes to spoofing and layering in the securities markets.[7]

## The Alleged Securities Markets Layering Scheme

The complaint alleges that from approximately December 2010 through at least September 2016, Avalon engaged in hundreds of thousands of instances of layering, involving hundreds of securities traded on numerous U.S. exchanges and other trading venues, which alone yielded profits of more than $21 million.[8]

The complaint summarizes Avalon's layering scheme as follows:

> Under this scheme, Avalon placed "non-bona fide orders"—in other words, orders that Avalon did not intend to execute and that had no legitimate economic reason—to buy or sell stock with the intent of injecting false information into the marketplace about supply or demand for the stock. Avalon did this to trick and induce other market

> participants to execute against Avalon's bona fide orders (i.e., orders that Avalon did intend to execute) for the same stock on the opposite side of the market. By placing the non-bona fide orders, Avalon was able to manipulate the market for stocks and thereby obtain more favorable prices on the executions of its bona fide orders than otherwise would have been available.[9]

According to the complaint, this type of trading behavior served only one purpose: to create a false impression of supply or demand to trick and induce others to trade so that Avalon could obtain a more favorable execution.[10] Although Avalon's profit on any single instance of layering might have been small, when multiplied by the hundreds of thousands of instances of layering in which it is alleged to have engaged, the profits totaled many millions of dollars.

The complaint further alleges that Fayyer and Pustelnik directly facilitated Avalon's layering scheme, and that Fayyer touted Avalon as a destination for traders who wanted to engage in layering, emphasizing in multiple communications that Avalon was one of the few trading firms that permitted layering.[11] Fayyer allegedly closely monitored trading activity by traders using Avalon's account at Lek Corp. to ensure that Avalon collected higher fees for layering.[12] Pustelnik allegedly participated in and substantially assisted the layering scheme in various ways, including by recruiting Avalon traders for the purpose of layering, falsely denying to Lek Corp. that Avalon was engaged in layering, and encouraging Lek Corp. to relax its internal control system designed to prevent layering.[13] Additionally, the complaint alleges that Fayyer and Pustelnik each received a share of Avalon's profits from the manipulative trading.[14]

The SEC also alleges that Lek Corp. and Samuel Lek helped make Avalon's layering scheme possible by providing Avalon with access to the U.S. securities markets that only a registered broker-dealer such as Lek Corp. could provide, implementing ineffective controls for layering and then relaxing those controls as needed in order to permit Avalon to continue its layering, and failing to implement any reasonable controls to prevent or detect layering.[15] As a result, Lek Corp. allegedly made significant profits from commissions and other amounts it earned from Avalon's layering.[16]

## The Relief Sought by the SEC

In its complaint, the SEC seeks: (1) entry of a permanent injunction prohibiting the Defendants from further violations of the relevant provisions of the federal securities laws; (2) disgorgement of ill-gotten gains, plus prejudgment interest; and (3) the imposition of civil monetary penalties.[17]

On March 10, 2017, as part of its enforcement action, the SEC sought and obtained a temporary restraining order ("TRO") freezing Avalon's assets held in its account at Lek Corp., as well as freezing and seeking to repatriate funds that Avalon allegedly transferred overseas.[18] The SEC sought this TRO because it believed that there was a substantial risk that once Avalon learned that the SEC filed suit against it, Avalon would try to move its funds, particularly those in the Avalon account at Lek Corp., overseas or otherwise beyond the reach of the Court.[19] Avalon responded to the SEC's TRO by moving to modify it to permit Avalon to access its frozen funds in order to pay its legal expenses and an expert witness, claiming that the SEC has not made a sufficient showing of a securities violation to warrant the TRO.[20] The SEC responded that: (1) Avalon has not and cannot show that the frozen funds are sufficient to satisfy any disgorgement remedy imposed by the court, nor can

Avalon show that the frozen funds are untainted by its manipulative conduct; and (2) Avalon has not shown that it needs the frozen funds in order to mount a legal defense. On March 29, District Judge Cote ruled that such modification would not be in the interest of the allegedly defrauded investors, that applicants have no general right to use frozen assets to pay legal fees, and that freezing the funds is necessary to ensure that there would be sufficient funds to satisfy any disgorgement remedy ordered at trial.[21] In addition, Judge Cote dismissed Avalon's argument that the SEC would be unable to show at the preliminary injunction hearing that Avalon or its co-defendants violated federal securities law because that issue would be addressed at the preliminary injunction hearing set to take place on August 2.[22]

On April 7, defendants Avalon, Lek Corp., and Samuel Lek filed motions in opposition of the SEC's motion for a preliminary injunction.[23] These motions argued that the SEC should not be granted a preliminary injunction because it has not shown a likelihood, or even an inference, that Avalon violated any securities laws—namely, the SEC has neither provided sufficient evidence to establish that Avalon's trading activity deviated from lawful high-frequency trading nor demonstrated manipulative intent.[24]

## The Take-Aways

There has been speculation about whether, in light of President Trump's promises to roll back the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the SEC and Commodity Futures Trading Commission ("CFTC") would focus their enforcement efforts away from complex market-based violations like spoofing and layering. Also, market participants, enforcers, and observers are waiting to see whether the U.S. Court of Appeals for the Seventh Circuit will find the commodity futures spoofing statue unconstitutional in U.S. v. Michael Coscia,[25] but the CFTC and SEC still have anti-fraud rules that they have used and continue to use to prosecute spoofing.[26]

As recently as March 15, 2017, Trump nominee and Acting CFTC Chairman J. Christopher Giancarlo explained that an organizational restructuring within the agency "will strengthen [the CFTC's] mission to identify and prosecute violations of law and regulation, such as spoofing, manipulation and fraud."[27] In a March 30, 2017 speech, Acting Chairman Giancarlo stated:

> The appointment of Jamie McDonald as CFTC Director of Enforcement is a signal that market enforcement will remain aggressive and assertive under the Trump Administration. It is a sign to those who may seek to cheat or manipulate U.S. markets that there will be no pause, no let up and no relaxation in the CFTC's mission to uncover and punish wrongdoing. [28]

Considering the statements of Acting Chairman Giancarlo, and the filing of the Lek case, it seems clear that the financial market regulators will continue to aggressively investigate and punish what they believe to be market-based frauds and manipulations like spoofing and layering.

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[1] *See* the complaint, SEC v. Lek Securities Corporation, Samuel Lek, Vali Management Partners d/b/a Avalon FA Ltd, Nathan Fayyer, and Sergey Pustelnik a/k/a Serge Pustelnik, Case No. 17 CV 1789, (S.D.N.Y. March 10, 2017), available at https://www.sec.gov/litigation/complaints/2017/comp-pr2017-63.pdf.
[2] *Id*. at ¶ 4.
[3] *Id*. at ¶ 1.
[4] The terms "layering" and "spoofing" are often used interchangeably to describe similar manipulative trading behavior—namely, offering to buy or sell a security or futures contract with the intent to cancel the order before it is executed. Layering, however, is a specific form of spoofing that involves placing multiple orders at different price levels, or "layers."
[5] Clifford C. Histed, *A Look At The 1st Criminal 'Spoofing' Prosecution: Part 1*, LAW 360, April 20, 2015, https://www.law360.com/articles/645167/a-look-at-the-1st-criminal-spoofing-prosecution-part-1.
[6] *See* SEC's Release # 2015-4, "SEC Charges Canadian Man With Conducting Fraudulent Trading Scheme," Jan. 13, 2015, https://www.sec.gov/news/pressrelease/2015-4.html.
[7] Additionally, on March 27, 2017, FINRA, along with the New York Stock Exchange; NYSE Arca; NYSE MKT; the four Bats Exchanges, Bats BZX, Bats BYX, Bats EDGA, and Bats EDGX; Nasdaq; Nasdaq BX; and the International Securities Exchange, announced that they have commenced disciplinary proceedings against Lek Corp. and Samuel Lek for their involvement in the two manipulative trading schemes. This Release can be found at http://www.finra.org/newsroom/2017/finra-exchanges-charge-lek-securities-its-ceo-aiding-abetting-securities-fraud.
[8] *See* complaint, *supra* note 1, at ¶ 35.
[9] *Id*. at ¶ 2.
[10] *Id*. at ¶ 40.
[11] *Id*. at ¶ 54.
[12] *Id*. at ¶ 57.
[13] *Id*. at ¶ 84.

[14] *Id*. at ¶ 59.
[15] *Id*. at ¶ 66. Lek Corp. and Samuel Lek are not the first brokers to be held accountable for the alleged spoofing violations of their customers. Advantage Futures LLC, a Futures Commission Merchant, and two of its executives were required to pay a civil monetary fine of $1.5 million by the CFTC for failing to take remedial action against a customer suspected of spoofing in several futures markets. *See* the CFTC Order in the Matter of Advantage Futures LLC, Joseph Guinan & William Steele, CFTC Docket No. 16-29, (Sept. 21, 2016), http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfsteeleorder092116.pdf.
[16] *Id*. at ¶ 7.
[17] *See* the complaint, *supra* note 1, at ¶ 11.
[18] SEC v. Lek Securities Corporation et. al, , Case No. 17 CV 1789, Dkt. No. 6. The SEC's motion for a temporary restraining order was supported, in part, by a declaration provided by market specialist Professor Terrence Hendershott of the University of California at Berkeley. Dkt. No. 14. Professor Hendershott also provided a declaration in support of the CFTC's motion for a statutory restraining order against Navinder Sarao, the so-called "Flash Crash" spoofer who pleaded guilty to spoofing and fraud in 2016. *See Declaration of Terrence Hendershott*, CFTC v. Nav Sarao Futures Limited PLC and Navinder Singh Sarao, Case No. 15 CV 3398 (N.D. Il. June 29, 2015), Dkt. No. 44-1.
[19] SEC v. Lek Securities Corporation et. al, Case No. 17 CV 1789, Dkt. No. 12.
[20] *Id*. at Dkt. No. 30, 31
[21] *Id*. at Dkt. No. 30, 31
[22] *Id*.
[23] *Id*. at Dkt. No. 50, 51.
[24] *Id*.
[25] U.S. v. Michael Coscia, Case No. 16-3017, (7th Cir.). The U.S. Court of Appeals for the Seventh Circuit is expected to release its opinion on the Michael Coscia futures spoofing appeal at any time. For more information about the Coscia case and practical guidance for futures trading in light of the "spoofing" statute, *see* Clifford C. Histed, supra note 5, and Clifford C. Histed, *A Look At The 1st Criminal 'Spoofing' Prosecution: Part 2*, LAW 360, April 21, 2015, https://www.law360.com/articles/645567/a-look-at-the-1st-criminal-spoofing-prosecution-part-2.
[26] *See* CFTC v. Igor B. Oystacher and 3Red Trading LLC, Case No. 15 CV 9196, (N.D. Ill. Oct. 19, 2015), where the CFTC alleged that the defendants had violated both the spoofing statute currently under review by the Seventh Circuit, and CFTC Regulation 180.1 which has not been challenged in an appellate court; and the SEC complaints in the Lek Corp. and Milrud cases where the SEC alleged that the defendants had violated SEC Rule 10-b5 by their alleged spoofing and layering schemes.
[27] Acting CFTC Chairman J. Christopher Giancarlo made this statement during his March 15, 2017 speech, "CFTC: A New Direction Forward," before the 42nd Annual International Futures Industry Conference in Boca Raton, Florida. A transcript of the speech can be found at http://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-20.
[28] Acting Chairman Giancarlo made these statements during his March 30, 2017 speech before the 11th Annual Capital Market Summit: Financing American Business, U.S. Chamber of Commerce called "Transforming the CFTC." A transcript of the speech can be found at http://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-21.