

Response to The NASDAQ Stock Market LLC; Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Provide a Process for an Expedited Suspension Proceeding and Adopt a Rule to Prohibit Disruptive Quoting and Trading Activity, File Number SR-NASDAQ-2016-074

This proposal from the NASDAQ acknowledges two very sobering realities of the functioning of today's securities markets: 1) Self-Regulatory Organizations ("SROs") can and do detect/observe and follow illegal behavior in the U.S. markets in real-time, or near real-time, and 2) if they act upon it they take years to resolve the issues as they continue to watch the same participants actively engaging in the illegal activity in real-time.

The SROs are mandated by Congress to protect investors and enforce all federal securities laws, rules and regulations and their own rules. The NASDAQ has proposed these new rules to allow it to prohibit disruptive trading (specifically layering and spoofing type activity), with an expedited suspension.

Spoofing and layering has previously been defined by the SEC as market manipulation. We do not believe NASDAQ should be creating new rules to isolate specific types of manipulative or disruptive activity outside of the general intent of Congress.

Since the inception of the 1930s Securities and Exchange Acts, market regulators have considered activity that artificially influences bids/offers to entice purchases and sales or alter prices as illegal (i.e. including spoofing and layering type activity).

The following is from a NASD n/k/a FINRA Hearing Panel Decision in 2000:¹

"The Fiero Respondents were charged with primary liability for these violations..... "[A] primary violator is one who 'participated in the fraudulent scheme' or other activity proscribed by the securities laws." Such participation may include "effecting the very buy and sell orders that artificially manipulated" the price of the Hanover Stocks. SEC v. U.S. Environmental, Inc., 155 F.3d 107, 111, 112 (2d Cir. 1998). That was precisely the role assumed by the Fiero Respondents in this case. Therefore, the Hearing Panel finds that the Fiero Respondents were properly charged."

In the same case, the NASD Hearing Panel quoted a 1977 U.S. Supreme Court decision:

"In enacting section 10(b) [of the Exchange Act], 'Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices.'" United States v. Regan, 937 F.2d 823, 829 (2d Cir. 1991), quoting Santa Fe Industries v. Green, 430 U.S. 462, 477 (1977)."

¹ NASD Regulation, Inc., Office Of Hearing Officers Department Of Enforcement v. Stephen Carlson, et al., Disciplinary Proceeding No. CAF980002 (CRD # 1008099), Hearing Panel Decision as to Respondents John Fiero and Fiero Brothers, Inc. (CRD # 1190133) (CRD # 27269) New York, NY, December 6, 2000
<http://www.finra.org/sites/default/files/OHODDecision/p006659.pdf>

The Fiero Respondents were charged with alleged violations of Section 10(b) of the Exchange Act, SEC Rule 10b-5, and NASD Rules 2120, 2110 and 3370.

By narrowing down to precise types of manipulation, future bad actors may attempt to manipulate securities prices under the guise of trading techniques or ‘ingenious devices’ that do not fall into the specific pre-defined categories, like those proposed here.

As shown below, rules currently exist for the NASDAQ to stop a wide variety of illegal activity in an expedited time period, including pre-execution layering and spoofing. Additionally, NASDAQ has a Regulatory Services Agreement with FINRA and FINRA also has existing rules/tools that allow it to halt disruptive and manipulative trading of any nature across all exchanges by FINRA members, including through cease and desist orders.

In other words, both NASDAQ and FINRA have the ability and duty to maintain fair and orderly markets and temporarily suspend a member firm executing or facilitating a pattern and practice of abusive behavior that is harmful to investors or the market.

Given the tools already exist for both NASDAQ and FINRA; we question the necessity and relevance to have an additional rule for these specific types of illegal activity that allows the NASDAQ to halt disruptive and manipulative trading. Is this proposal intended to provide an appearance of active, tough enforcement without changing the SRO’s actual enforcement program, which recent history shows to be a minimalist approach taking significant time to implement against its’ members acting abusively?

NASDAQ’s proposal states that both it and other SROs,

“were able to identify the disruptive quoting and trading activity in *real-time or near real-time*; nonetheless, in accordance with Exchange Rules and the Act, the Members responsible for such conduct or responsible for their customers’ conduct were allowed to continue the disruptive quoting and trading activity on the Exchange and other exchanges during the *entirety of the subsequent lengthy investigation and enforcement process.*”

This is dangerous for the capital markets. SROs (the **first line of defense** against securities fraud put in place by Congress) can detect and follow the troublesome activity and appear to have all the necessary tools to stop the bad behavior and enforce compliance with their orders. Exchange SROs can rely on FINRA as a secondary authority and even bring in the SEC if required to protect investors, other professional participants and the marketplace.

However, this proposal suggests they believe they do not have the ability to perform timely enforcement, which appears squarely contradictory to existing regulations and the SROs’ historical statements and indications to listed issuers and their shareholders.

While this above statement of fact is in the proposal, "in accordance with *Exchange Rules and the Act*, the Members responsible for such conduct or responsible for their customers’ conduct were allowed to continue", NASDAQ does not cite any prohibitions from the Exchange Rules and the Act stopping them from enforcing their duties to protect investors and the markets from known fraud. NASDAQ should cite the rules that prevent them from enforcing securities law and halting ongoing fraud.

SROs have been on record touting their sophisticated abilities for years.² The importance of the SROs' effective and efficient enforcement of the securities laws simply cannot be argued.

We have provided several examples through various comment letters of numerous securities that appear to require real-time enforcement because of abusive market behavior, including excessive short selling and apparent non-compliance with rules governing the settlement of securities transactions. Moreover, we have shown through multiple securities that some market participants are clearly avoiding proper reporting of transactions in order to circumvent regulations that should be enforced by SROs.³ Perhaps, if the exchanges and FINRA would have acted in real-time during the financial crisis of 2008/2009, they might have changed the outcome.

In this proposal, NASDAQ discusses three examples. It claims to have discovered the abusive trading executed by clients of Biremis in 2007, but the activity continued until 2012 when the firm was barred. The activity executed by clients of Hold Brothers was discovered in 2009, but the enforcement action was not concluded until 2012, regardless of the fact that the illegal activity continued for years. Third, NASDAQ discusses the criminal case against Navinder Singh Sarao for activity contributing to the May 2010 Flash Crash, but his abusive trading continued through 2015.

² NASDAQ states: "Nasdaq is a leading provider of trading, clearing, exchange technology, listing, information and public company services across six continents. Through its diverse portfolio of solutions, Nasdaq enables customers to plan, optimize and execute their business vision with confidence, using proven technologies that provide transparency and insight for navigating today's global capital markets. As the creator of the world's first electronic stock market, its technology powers more than 70 marketplaces in 50 countries, and 1 in 10 of the world's securities transactions. Nasdaq is home to more than 3,500 listed companies with a market value of over \$9.1 trillion and more than 10,000 corporate clients." <http://ir.nasdaqomx.com/>

FINRA states: "Every day, FINRA oversees up to 75 billion market transactions, using technology powerful enough to detect potential abuses." <https://www.finra.org/about/technology>

FINRA further states: "FINRA provides the first line of oversight for broker-dealers and the first line of defense for investors by virtue of its comprehensive oversight program. FINRA regulates both the firms and professionals selling securities in the United States and the U.S. securities markets. In this capacity, FINRA writes and enforces its own rules, as well as enforcing federal securities rules and laws." <http://www.finra.org/industry/oversight>

³ SEC Request for Comment on Exchange-Traded Products, *Response to SEC Questions Regarding Exchange Traded Products*, File Number S7-11-15 <http://www.sec.gov/comments/s7-11-15/s71115-19.pdf>

Follow up to the above SEC Request for Comment on Exchange-Traded Products, *The ETF Stress Test of August 24, 2015*, File Number S7-11-15 <http://www.sec.gov/comments/s7-11-15/s71115-38.pdf>

SEC Request for Comment on Open-End Fund Liquidity Risk Management Programs, *Response to SEC Questions Regarding Open-End Fund Liquidity Risk Management Programs*, File Number S7-16-15 <https://www.sec.gov/comments/s7-16-15/s71615-60.pdf>

Response to SEC Questions Regarding the Use of Derivatives by Registered Investment Companies and Business Development Companies File Number S7-24-15, March 28, 2016 <https://www.sec.gov/comments/s7-24-15/s72415-111.pdf>

Follow-Up Response to SEC Questions Regarding the Use of Derivatives by Registered Investment Companies and Business Development Companies, File Number S7-24-15, April 11, 2016 <https://www.sec.gov/comments/s7-24-15/s72415-192.pdf>

Second Follow-Up Response to SEC Questions Regarding the Use of Derivatives by Registered Investment Companies and Business Development Companies, File Number S7-24-15, April 28, 2016 <https://www.sec.gov/comments/s7-24-15/s72415-200.pdf>

NASDAQ states it,

“believes that it should have the authority to initiate an expedited suspension proceeding in order to stop the behavior from continuing on the Exchange if a Member is engaging in or facilitating disruptive quoting and trading activity and the Member has received sufficient notice with an opportunity to respond, but such activity has not ceased.”

Again, NASDAQ appears to have all the necessary tools available to halt the alleged illegal activity it was watching on a continuous basis. Moreover, FINRA, as an agent of the NASDAQ and the overall industry supervisor also had/has the tools available.

In the case of Hold Brothers, NASDAQ found it violated NASDAQ Rule 2110, Section 17(a) of the Securities Act and several additional NASDAQ and SEC rules.⁴ Under the currently existing NASDAQ rules, for these specific violations the SRO had the ability to obtain a cease and desist order against Hold Brothers and temporarily suspend Hold Brothers if it did not comply.

Moreover, the SRO mandate by Congress to protect investors and, in essence, the market itself has already existed for decades. While on the surface there is no reason not to adopt this rule, there does not appear to be any reason to believe this will enhance enforcement because NASDAQ’s ability to enforce laws, rules, regulations and its own rules already exists.

The real question here is, will the new NASDAQ rules generate any enforcement actions in a faster time frame? Under the existing rules NASDAQ, FINRA and the other SROs have not provided real-time enforcement, which is confirmed by NASDAQ’s arguments set forth in the new rules.

There are endless examples of abusive manipulative trading occurring across the markets that the SROs claim they can detect in real-time, or almost real-time, that go unchecked for years. How will these proposed rules change the NASDAQ/FINRA enforcement regime that has been highly criticized within the securities industry for having very serious and obvious conflicts of interest?

Some say the SRO system is broken because of the inherent business conflicts of interest and that SROs have developed a culture of non-enforcement of securities laws. It appears this cultural problem may be seriously affecting the proper functioning of the SROs’ mandated duties.

When enforcement actions are brought years after the activity began and the fines and penalties are minimal (a ‘cost of doing business’), bad behavior is essentially reinforced. Rather than being in a position of protecting investors and the markets as mandated by Congress, through non-enforcement the SROs are enabling the very behavior that causes systemic risk to the vitally important U.S. financial system.

⁴ NASDAQ found Hold Brothers violated Sections 9(a)(1) and 9(a)(2) of the Exchange Act, Section 17(a) of the Exchange Act and SEC Rules 17a-3 and 17a-4, and NASDAQ Rules 2120, 3310, IM-3310, 3320, 2110, 3010(a), 3010(b) and 3110. See Letter of Acceptance, Waiver and Consent No. 20100233513-01, Re: Hold Brothers Online Investment Services LLC, dated September 24, 2012
<https://www.finra.org/sites/default/files/p178690%20%3D%20NASDAQ%20Stock%20Market%20LLC%20%E2%80%93%20Hold%20Brothers%20On-Line%20Investment%20Services%2C%20LLC%20Action.pdf>

This is possibly the most central problem that is disrupting a well-functioning market (i.e. lax or no enforcement by the front-line gatekeepers/defenders of the financial system of the laws, rules and regulations that are designed to operate a fair and orderly market based on true supply and demand). No minor rule changes can alleviate this problem.

In today's fast-paced market environment, it is important that SROs monitor for manipulative behavior that is damaging to the markets and investors on a daily basis. It is alarming when this activity is being recognized, but not quickly and effectively acted upon.

The sole purpose to exist as SROs, as the exchanges have argued for decades, is for their unique understanding of how the markets operate and ability to supervise and stop market participants from performing bad acts. If they cannot or will not fulfill this responsibility, why do they enjoy the SRO status? Must SROs be forced to fulfill their congressional mandates by holding SROs and the executives accountable for their actions or lack thereof? Is it time to transparently re-evaluate the SRO structure and how exchanges should operate?

NASDAQ Rules

Below are the applicable NASDAQ and FINRA rules that already exist and apply to NASDAQ and FINRA members. The NASDAQ did not explain how the newly proposed rules supplement NASDAQ's and its' enforcement partner, FINRA's, existing authority under NASDAQ rules 9290, 9556, 9810 and 9860, other than giving an illusion that something will/has changed. The new rules appear to add little or nothing to the ability of NASDAQ and FINRA to enforce securities laws and their own rules through their already existing tools to stop abusive and egregious behavior against companies and their shareholders.⁵

9290. Expedited Disciplinary Proceedings

For any disciplinary proceeding, the subject matter of which also is subject to a temporary cease and desist proceeding initiated pursuant to Rule 9810 or a temporary cease and desist order, hearings shall be held and decisions shall be rendered at the earliest possible time. An expedited hearing schedule shall be determined at a pre-hearing conference held in accordance with Rule 9241.

9556. Failure to Comply with Temporary and Permanent Cease and Desist Orders

(a) Notice of Suspension, Cancellation or Bar

If a member, person associated with a member or person subject to Nasdaq's jurisdiction fails to comply with a temporary or permanent cease and desist order issued under the Rule 9200, 9300 or 9800 Series, Nasdaq Regulation staff — after receiving written authorization from the Chief Regulatory Officer — may issue a notice to such member or person stating that the failure to comply with the temporary or permanent cease and desist order within seven days of service of the notice will result in a suspension or cancellation of membership or a suspension or bar from associating with any member.

⁵ The proposed rule may allow the NASDAQ authority to sign a cease and desist order without obtaining a FINRA executive signatory. However, they have working agreements with each other, thus this change alters little in their current ability to impose expedited suspensions.

9800. Temporary Cease and Desist Orders

9810. Initiation of Proceeding

(a) Department of Enforcement or Department of Market Regulation

With the prior written authorization of the FINRA's Chairman and CEO or FINRA's Senior Executive Vice President for Regulatory Policy and Programs, the Department of Enforcement or the Department of Market Regulation may initiate a temporary cease and desist proceeding with respect to alleged violations of Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 thereunder; SEC Rules 15g-1 through 15g-9; Nasdaq Rule 2110 (if the alleged violation is unauthorized trading, or misuse or conversion of customer assets, or based on violations of Section 17(a) of the Securities Act of 1933); Nasdaq Rule 2120; or Nasdaq Rule 2150 (if the alleged violation is misuse or conversion of customer assets). The Department of Enforcement or the Department of Market Regulation shall initiate the proceeding by serving a notice on a member or associated person (hereinafter "Respondent") and filing a copy thereof with the Office of Hearing Officers. The Department of Enforcement or the Department of Market Regulation shall serve the notice by personal service, overnight commercial courier, or facsimile. If service is made by facsimile, the Department of Enforcement or the Department of Market Regulation shall send an additional copy of the notice by overnight commercial courier. The notice shall be effective upon service.

9860. Violation of Temporary Cease and Desist Orders

A Respondent who violates a temporary cease and desist order imposed under this Rule Series may have its association or membership suspended or canceled under Rule 9556. The Chief Regulatory Officer of Nasdaq must authorize the initiation of any such proceeding in writing.

FINRA Rules

9290. Expedited Disciplinary Proceedings

For any disciplinary proceeding, the subject matter of which also is subject to a temporary cease and desist proceeding initiated pursuant to Rule 9810 or a temporary cease and desist order, hearings shall be held and decisions shall be rendered at the earliest possible time. An expedited hearing schedule shall be determined at a pre-hearing conference held in accordance with Rule 9241.

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If a member, person associated with a member or person subject to FINRA's jurisdiction fails to comply with a temporary or permanent cease and desist order issued under the Rule 9200, 9300 or 9800 Series, FINRA staff, after receiving written authorization from FINRA's Chief Executive Officer or such other senior officer as the Chief Executive Officer may designate, may issue a notice to such member or person stating that the failure to comply with the temporary or permanent cease and desist order within seven days of service of the notice will result in a

suspension or cancellation of membership or a suspension or bar from associating with any member.

9800. TEMPORARY CEASE AND DESIST ORDERS

9810. Initiation of Proceeding

(a) Department of Enforcement or Department of Market Regulation

With the prior written authorization of FINRA's Chief Executive Officer or such other senior officers as the Chief Executive Officer may designate, the Department of Enforcement or the Department of Market Regulation may initiate a temporary cease and desist proceeding with respect to alleged violations of Section 10(b) of the Exchange Act and SEA Rule 10b-5 thereunder; SEA Rules 15g-1 through 15g-9; FINRA Rule 2010 (if the alleged violation is unauthorized trading, or misuse or conversion of customer assets, or based on violations of Section 17(a) of the Securities Act); FINRA Rule 2020; or FINRA Rule 4330 (if the alleged violation is misuse or conversion of customer assets). The Department of Enforcement or the Department of Market Regulation shall initiate the proceeding by serving a notice on a member or associated person (hereinafter "Respondent") (or upon counsel representing the Respondent, or other person authorized to represent others under Rule 9141, when counsel or other person authorized to represent others under Rule 9141 agrees to accept service for the Respondent) and filing a copy thereof with the Office of Hearing Officers. The Department of Enforcement or the Department of Market Regulation shall serve the notice by personal service, overnight commercial courier, facsimile, or email. If service is made by facsimile or email, the Department of Enforcement or the Department of Market Regulation shall send an additional copy of the notice by personal service or overnight commercial courier. Service is complete upon sending the notice by facsimile or email, sending the notice by overnight courier or delivering it in person, except that, where duplicate service is required, service is complete when the duplicate service is complete. The notice shall be effective when service is complete.

9860. Violation of Temporary Cease and Desist Orders

A Respondent who violates a temporary cease and desist order imposed under this Rule Series may have its association or membership suspended or canceled or be subject to any fitting sanction under Rule 9556. FINRA's Chief Executive Officer or such other senior officer as the Chief Executive Officer may designate must authorize the initiation of any such proceeding in writing.