IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

v.

LEK SECURITIES CORPORATION, et al.,

Defendants.

Civil Action No. 17-CV-1789 (DLC)

DEFENDANT AVALON FA LTD'S MEMORANDUM OF LAW
IN OPPOSITION TO PLAINTIFF'S MOTION FOR PRELIMINARY INJUNCTION

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The Securities and Exchange Commission ("SEC") has not established a strong likelihood, or even an inference, that Defendant Avalon FA LTD ("Avalon") has violated the federal securities laws. The conduct alleged by the SEC is indistinguishable from legal trading activity. It violated no statute, rule or regulation. The SEC cannot infer manipulative intent from lawful conduct. Because, the SEC cannot show securities laws violations, its request for preliminary injunctive relief should be denied.

Summary

The SEC alleges that Avalon engaged in what it calls "layering." Essentially, the SEC accuses Avalon's traders of entering orders to buy or sell securities at prices better than the current market, while supposedly intending that those orders not be executed. For example, if the inside bid – i.e. the highest price that any market participant was then willing to pay to purchase shares of a stock – was $10, the SEC alleges that Avalon traders might have entered an order to buy stock at $10.01. If another unaffiliated market participant stepped ahead of that order by bidding $10.02, Avalon traders might have tried entering another order to buy stock at $10.03, *et cetera*. The SEC claims to know, and asserts that it can prove, that, at the time the trader placed these orders, in the trader's heart, she did not actually want those orders to be executed. The SEC claims to know this, not because it has spoken with any trader or obtained any admissions, but rather, merely because those orders were sometimes not executed and subsequently canceled.

A trader has no control over whether his open market order is executed – i.e. finds a willing buyer or seller. That depends entirely upon the unpredictable whims of the market. It is hard to imagine, though, a more convincing way to evidence a sincere desire to trade than to publicly offer to pay the highest price. A trader has no ability to "back away" or not complete a trade should a market counterparty execute his open orders. But also nothing precludes other

market participants (or, as is usually the case, other market participants' algorithmic trading computers) from coming along milliseconds later and offering an even better price that causes the trader's order to go unexecuted. This, of course, does not mean that the trader did not intend to trade. Rather, it only demonstrates that the trader was *precluded* from trading at his offered price by other market participants who, in that moment, were more determined to acquire or dispose of stock, and thus offered even better prices.

The only "evidence" cited by the SEC to prove Avalon traders' alleged intentions not to execute is the subsequent cancelation of orders that had become unmarketable. But, according to the SEC's own website, the average cancel-to-execution ratio for stock orders is approximately 20 to 1.[1] The SEC is thus asking the Court to infer manipulation intent from something expected to happen 19 out of every 20 times a trader places an order – *i.e.* that a trader does not get the price he wanted and has to then cancel his order. The SEC will never be able to overcome the innumerable plausible nonculpable explanations for the trading activity it seeks to vilify.

That is because the activity at issue is *indistinguishable* from normal trading. Neither the SEC nor its expert alleges that any individual order or transaction at issue was placed or executed in a manner that violated any exchange rule or any market regulation. Nor can it be plausibly alleged that these open orders constituted any deception on the market. They were exactly what they purported to be – offers to buy or sell specific securities at specific prices. They conveyed the same accurate information as any other limit order in the market – that a buyer or seller exists

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[1] https://www.sec.gov/marketstructure/datavis/ma_overview.html#.WMrYB7GVSL5. Mary Shapiro, the former chairperson of the SEC, estimated that high-frequency traders cancel "at least 90 percent of their orders." Jesse Westbrook, *SEC Considers Rules for High-Frequency Traders After Plunge*, Bloomberg (Sept. 7, 2010).

for a certain number of shares at a certain price. At anytime those orders were open, the market could have successfully acted on that information by executing the trader's order.

The SEC might counter that the trader's subjective desire to execute particular orders and not others was "undisclosed." But that information, even if true, would be immaterial to the market. The orders at issue are real – they exist and are executable regardless of the trader's supposed hopes and dreams for those orders. Any market participant could have accepted any of those offers and irrevocably committed the Avalon trader to that trade regardless of that trader's subjective desire for that order. What matters to the market, if anything, is the trader's objective willingness to trade as evidenced by his actual offer to buy or sell securities.

Moreover, traders in the marketplace always endeavor not to reveal their subjective intentions. If Fidelity, for example, needed to sell a million shares of a stock in one of its mutual funds, its trader would not go to the open market with an offer for a million shares at the inside ask. If she did, the market would know that someone needed to sell an enormous amount of shares and the price would run away from Fidelity. To avoid selling at increasingly lower prices, Fidelity's trader would attempt to not reveal and actively conceal her true intentions. She would sell small amounts through different broker dealers and different exchanges. She would enter hidden or reserve orders that do not display in the open market. She would execute through "dark pools" that would help conceal her size. She might have even bought some more shares if her selling lowers the price, thereby "buying down" the weighted-average price she needs to achieve to clear her inventory. All of these orders are intended to and do obscure the Fidelity trader's true subjective intention to sell a large amount of shares, which if known to the market would arguable result in a more "accurate" price. All of those orders, and many more like them, are nonetheless legal under the federal securities laws.

The alleged activity is not outside "the natural interplay of supply and demand." Rather, it *is* the natural flow of supply and demand in action at its purest. The SEC and its expert make the unrealistic assumption that the activity at issue takes place in a vacuum where the only relevant information of concern to the market for highly liquid securities was that which was conveyed by the small limit orders placed by Avalon traders. Even accepting for purposes of argument that untrue perspective, the SEC's theory misconstrues basic supply and demand. If an Avalon trader placed an order for $10.01, the market, ignoring all other available information, may have reacted to that new order in at least four ways. First, and most likely, the market could simply ignore the order – even in a hypothetical vacuum, the SEC has failed to explain why small anonymous limit orders would predictably induce any reaction from the market. Two, market participants could have matched that price because they thought it was a good price to buy and they wanted to participate should any sellers appear. Three, they could have thought it was an expensive price and executed the order by selling to the Avalon trader at $10.01. Or four, they could have thought that if a buyer was willing to pay $10.01 – a price already better than the previous inside market – maybe buyers would be willing to pay even more. In that last case, the market participant might bid higher to $10.02. Now that market participant would be on the inside, the same choices, amongst others, would then be available to the Avalon trader. There is no distinction between the Avalon trader's order and the bid placed over the top of that order by another market participant. Both conveyed the same information and presented the same choices for the market. If Avalon's trader hypothetically were to react by entering a new order to buy at $10.03, the same market participant that bid $10.02 might now sell to Avalon's trader at $10.03 having successfully raised the price he received by $0.02 from the trader's original order. Or

maybe the market participant would make one more raise to $10.04, and the Avalon trader might decide to sell on that bid, which she now considered too high.

This is how the market works. Participants place bids and offers; other market participants join, execute or improve those bids and offers. Traders are not required to commit indefinitely to one side of the market. A buyer at one price is also a seller at another, higher, price. No market participant ever voluntarily reveals his true intentions as to whether and what price he is willing to buy or sell, nor is he required to. Rather, it is this competition between where buyers are willing to buy and sellers are willing to sell that creates the market prices at which trades are executed.

The SEC's suggestion that Avalon trader orders moved prices to artificial levels is nonsense. There is no "true" price in the market; there is only the price that the market will bear. If the market for a particular security is $10 bid and $10.10 ask, and an Avalon trader bids $10.01, and then immediately after, another unaffiliated market participant bids $10.02 – (i) how is that new price the Avalon trader's responsibly, (ii) how is that new bid any more or less manipulative than the order at $10.01 and (iii) who is to say that $10.02 is an "artificial" price? It is a real price that a real market participant that is not in anyway affiliated with Avalon is willing to buy based on all the information available to him, including the true and public information that another trader has placed an order to buy at $10.01. That price can be considered artificial only if one accepts the SEC's unsupportable proposition that placing an order and being out bid somehow illegitimizes the original order. Under the SEC's theory, any trader that submits a bid or offer that improves the market is subject to potential liability beyond their control if that order is subsequently out bid or offered by another market participant. That is not the law.

The impossibility of distinguishing "legitimate" and "illegitimate" orders and trades under the SEC's theory perhaps explains why the SEC has not attempted to exercise its rule-making authority to prohibit so-called "layering." What would such a rule even say? Would it incorporate the language of Mr. Hendershott's report and prohibit the execution of trades where the trader has open orders on the other side of the market? If so, that would prohibit all market making activity, the engine that drives all trading, literally "making the market" on modern exchanges. Or perhaps the SEC would only prohibit trades, *post hoc*, if it turned out after the trade was executed that opposite side orders were not filled at their offered prices and had to be cancelled. This would require market makers and other dual-side traders to hold open indefinitely stale bids and offers in a moving market or face the potential that its previous opposite side trades be branded illegitimate. Regardless of how Congress or the SEC *might* overcome these challenges, it is clear they have not yet done so. As it stands, there is no statute, SEC rule, or exchange regulation that prohibits so-called "layering" in the equity markets as alleged by the SEC.

Argument

I. SEC Cannot Meet It Burden For Issuance Of Injunction

"The basic principles governing the issuance of injunctions sought by the Government were set forth by the Supreme Court in *Hecht Co. v. Bowles.*" *SEC v. Unifund*, 910 F.2d 1028, 1035 (1990). In that case, the Supreme Court admonished:

> The historic injunctive process was designed to deter, not to punish. The essence of equity jurisdiction has been the power of the [Court] to do equity and to mold each decree to the necessities of the particular case. Flexibility rather than rigidity has distinguished it. The qualities of mercy and practicality have made equity the instrument for nice adjustment and reconciliation between the public interest and private needs.

321 U.S. 321, 329-30 (1944).

This Court's equity jurisdiction under Section 20(b) of the Securities Act and Section 21(d) of the Exchange Act (collectively, the "Securities Acts") is properly "invoked *by a showing of a securities law violation*." *SEC v. Manor Nursing Ctrs., Inc.*, 458 F.2d 1082, 1103 (2d Cir. 1992); *SEC v. One or More Unknown Traders*, 296 F.R.D. 241, 254 (S.D.N.Y. 2013) (emphasis added). Both provisions authorize the SEC to seek injunctive relief against parties "engaged or about to engage in any acts or practices which constitute or will constitute a violation" of the Securities Acts. 15 U.S.C. § 77t(b) and 15 U.S.C. § 78u(d).

In this case, the SEC is seeking an unprecedented and unwarranted expansion of "manipulation" liability based upon a fact pattern that has never before been found violative of any federal securities law. No court or administrative judge has ever before examined and condemned the conduct at issue – entering double sided orders and cancelling orders that are not filled. There is no statute, rule or regulation that forbids "layering" as alleged by the SEC. To the contrary, every single one of the orders and trades challenged by the SEC conformed in every respect with the rules of the various exchanges upon which they were posted and/or executed.

As the Supreme Court has explained:

> "Manipulation" is virtually a term of art when used in connection with the securities markets. The term refers generally to practices, such as wash sales, matched orders, or rigged prices that are intended to mislead investors by artificially affecting market activity.

Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 476 (1977). Avalon's alleged trading does not meet this traditional concept of "manipulation." There are no allegations of wash sales, no pump and dump, no boiler room; nothing other than the posting of actual orders in the open market that do not always get filled.

"In fashioning preliminary relief, district courts retain ample discretion to assess all the all the relevant circumstances and, in those cases where the Commission has demonstrated entitlement to a freeze order, to determine the coverage, terms and duration of that order." *SEC v. Unifund*, 917 F.2d 98, 99 (2d Cir. 1990). Under current precedent, the proper showing to support an SEC asset freeze is less than the usual standard for a preliminary injunction, but still requires a showing of either a likelihood of success on the merits or that an inference can be drawn that the defendant violated the federal securities laws. *Smith v. SEC*, 653 F.3d 121, 128 (2d Cir. 2011).[2] Moreover, the scope and duration of the asset freeze sought should be proportionate to

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[2] Avalon acknowledges that in *Smith* the Second Circuit stated that the SEC may obtain an asset freeze on a mere showing of an inference of a securities law violation. Avalon, however, questions both the continued viability and the rationale for that standard. In *Smith*, the standard for an asset freeze was not at issue, thus the statement espousing that standard is just dicta. Moreover, its support for that proposition is not other binding Second Circuit precedent, but instead only this Court's unreported decision in *SEC v. Byers*, No. 08 Civ. 7104, 2009 WL 33434, at *3 (S.D.N.Y. Jan. 7, 2009).

Unifund is the only Second Circuit decision that has ever affirmed an asset freeze on the basis of the mere showing of an inference of a securities law violation. However, because of the scarcity of the SEC's showing in that case, the Court limited the freeze to 30 days *and* permitted the defendants to continue to trade the otherwise frozen assets. 910 F.2d at 1042-43. Second Circuit decisions subsequent to *Unifund* have confirmed the traditional rule that an indefinite and complete asset freeze of the sort sought by the SEC in this case requires a showing of likelihood of success on the merits. *See, e.g., S.E.C. v. Cavanagh*, 155 F.3d 129, 132 (2d Cir. 1998) ("An asset freeze requires a lesser showing; the SEC must establish only that it is likely to succeed on the merits.") In *Cavanagh*, the Second Circuit recognized the well-established rule that "[u]nlike a private litigant, the SEC need not show risk of irreparable injury." However, there is no legitimate reason why the SEC should also have the benefit of a relaxed showing on the merits as compared to a private litigant seeking a prejudgment attachment. *See e.g. DLJ Mortg. Capital, Inc. v. Kontogiannis*, 594 F. Supp. 2d 308, 318–19 (E.D.N.Y. 2009) ("Under New York law, a plaintiff may obtain an order of attachment if it demonstrates that (1) it has stated a claim for a money judgment; (2) it has a probability of success on the merits; (3) the defendant, "with the intent to defraud his creditors or frustrate the enforcement of a judgment that might be rendered in plaintiff's favor, has assigned, disposed of, encumbered, or secreted property, or removed it from the state or is about to do any of these acts," and (4) the amount demanded from the defendant is greater than the amount of all counterclaims known to plaintiff. N.Y. C.P.L.R. §§ 6212(a), 6201(3)." While Avalon recognizes the Court is bound by Second Circuit precedent,

the certainty of the SEC's showing. *See, e.g., Unifund*, 910 F.2d at 1042; *One or More Unknown Traders,* 296 F.R.D. at 256.

"While the primary purpose of freezing assets is to facilitate compensation of defrauded investors in the event a violation is established at trial, 'the disadvantages and possible deleterious effect of a freeze must be weighed against the considerations indicating the need for such relief.'" *Id.* (*quoting SEC v. Manor Nursing Ctrs., Inc.,* 458 F.2d 1082, 1105 (2d Cir. 1972)). "Like any private litigant, the SEC's burden of proof rises in relation to the hardship the injunction would create for the defendant." *SEC v. Gonzalez De Castilla*, 145 F. Supp. 2d 402, 415 (S.D.N.Y. 2001).

Moreover, as in this case, where the theory of liability presented by the SEC is novel and previously untested, the Second Circuit has recognized that the Court should more narrowly limit the scope of any requested asset freeze. *See Unifund*, 910 F.2d at 1042-43. In *Unifund*, the SEC sought for the first time to impose liability for insider trading without identifying the "tipper" – *i.e.* the person or entity alleged to have improperly conveyed the inside information to the defendant. *Id.* at 1040. Because a defendant's liability for insider trading is dependent on whether the tipper knowingly breached a duty in conveying the nonpublic information, *see Dirks v. SEC*, 463 US 646, 659 (1983), the SEC's theory in *Unifund* was, at that time, practically unprecedented. *Unifund,* 910 F.2d at 1040-41. The court determined that the SEC's novel theory presented a "minimal showing of a violation." *Id.* at 1041. Thus, the Second Circuit overturned a preliminary injunction precluding defendants from engaging in further violations of the securities laws and modified the lower court's asset freeze to limit it to no longer than 30 days and to allow the defendants to continue to trade the otherwise frozen funds. *Id.* at 1043.

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although not dicta, it believes that the Court should require the SEC to at least establish that it is likely to succeed on the merits before issuing the indefinite and complete asset freeze requested.

In this case, not only can the SEC not show a likelihood of success on the merits, not even an "inference" of wrongdoing can be shown where the conduct at issue does not violate any federal securities law. It is the SEC's burden to demonstrate that a statute or rule prohibits the conduct alleged – executing a trade on one side or the market and subsequently cancelling unfilled orders on the other side of the market. The SEC cannot meet that burden and thus the requested injunction must be denied.

II. No Statute Or Rule Prohibits So-Called "Layering"

A. There Is No Liability For "Layering" Under Section 9(a)(2) of The Exchange Act

The only statute the SEC has even suggests specifically addresses the conduct at issue here is Section 9(a)(2) of the Exchange Act. (*See* Hearing Tr.; Mem. Opp. Avalon's Request To Access Frozen Funds ("Opp. Mem.").) Section 9(a)(2), which was enacted in 1934 before the existence of electronic markets, makes it unlawful to:

> Effect . . . *a series of transactions* in any security . . . creating actual or apparent active trading in such security, or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such securities by others.

15 U.S.C. § 78i (emphasis added).

In both of the two most prominent decisions on securities manipulation, the Supreme Court emphasized, "The starting point in every case involving construction of a statute is the language itself." *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 197 (1976); *Santa Fe Industries v. Green,* 430 U.S. 462, 472 (1977). This Court is required to begin "with the principle that '(a)scertainment of congressional intent with respect to the standard of liability created by a particular section of the (1933 and 1934) Acts must . . . . rest primarily on the language of that section.'" *Santa Fe Industries,* 430 U.S. at 472, *quoting Ernst & Ernst,* 425 U.S. at 200.

By its plain language, Section 9(a)(2) outlaws certain "*series of transactions*." According to English Oxford Dictionary, a "transaction" is "an instance of buying or selling something." The SEC has adopted Rule 10b-10 entitled "Confirmation of transactions," which throughout likewise conveys the SEC's understanding that a "transaction" is a completed purchase or sale. *See* 17 C.F.R. § 240.10b-10 (for example, requiring a confirmation to include "the date and time of the transaction . . . and the identity, price, and number of shares . . . *purchased or sold*" (emphasis added).) Conversely, in Rule 600, the SEC has separately defined a "customer limit order" to mean "an order to buy or sell . . . at a specific price" and defined a "bid or offer" to mean "the bid price or the offer price communicated by a member . . . to any broker or dealer, or to any customer, at which it is willing to buy or sell." 17 C.F.R. 242.600.

The SEC has alleged that Avalon traders entered a series of customer limit orders that they did not intend to execute and, in fact, did not execute. The SEC has alleged that it is these orders that somehow deceived the market. Even if correct, the SEC has not alleged any manipulative "transactions."

The SEC has attempted to mislead the Court on this issue in its Opposition Memorandum to Avalon's Request to Access Frozen Assets ("Opp. Mem."). The SEC cites a Southern District case, *SEC v. Malenfant*, 784 F. Supp. 141 (S.D.N.Y. 1992), for the proposition that "courts in this district have recognized that an illegal manipulation under Section 9(a)(2) can involve unexecuted orders." Opp. Mem. at 7. However, the Court in *Malenfant* was considering claims under the wash sale prohibitions of Sections 9(a)(1)(b) and (c), which explicitly outlaws wash sale "orders." 784 F. Supp. at 144. The SEC has not alleged any wash sales in this case, and has not alleged violations of Section 9(a)(1)(b) or (c).

Rather, those provisions in the same statute relied upon by the SEC highlight Congress' intent not to outlaw "orders" under Section 9(a)(2). Section 9(a)(1)(b) and (c) make it unlawful:

> For the purpose of creating a false or misleading appearance of active trading in a security . . . to enter *an order or orders* for the purchase of such security with the knowledge that an order or orders of substantially the same size, at substantially the same time, and at substantially the same price, for the sale of any such security has been or will be entered by or for the same or different parties, or to enter any *order or orders* for the sale of any such security with the knowledge that an order or orders of substantially the same size, at substantially the same time, and at substantially the same price, for the purchase of such security, has been or will be entered by or for the same or different parties.

15 U.S.C. § 78i(a)(1). Thus it is clear that Congress knew how to make "orders" unlawful in addition to completed "transactions" when enacting Section 9 of the Exchange Act. In Section 9(a)(2), Congress chose to address only "transactions," demonstrating a clear congressional intent to not prohibit "orders" under that portion of the statute.[3] *Cruz-Miguel v. Holder*, 650 F.3d 189, 196 (2d Cir. 2011) ("But where as here, Congress 'uses certain language in one part of the statute and different language in another, the court assumes different meanings were intended." (*quoting Sosa v. Alvarez-Machain*, 542 U.S. 692, 711 n.9 (2004)). Neither the SEC nor this Court can permissibly expand the plain language of the statute to create additional liability not enacted by Congress. *Ernst & Ernst*, 425 U.S. at 213 (holding the SEC cannot expand liability for securities manipulation beyond "the will of Congress as expressed by the statute").

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[3] There is an easy explanation for why Congress chose to prohibit only executed transactions in Section 9(a)(2). That section was intended to address what was 1934 called "speculator pools," or what now might be called "boiler room" schemes. Such speculator pools were "trade-based" manipulative schemes involving members of the pool repeatedly executing trades in the penny stocks in order to "paint the tape" – i.e. give the appearance of actual trading activity and market interest. *See* Daniel R. Fischel, *Should The Law Prohibit "Manipulation" In Financial Markets?*, 105 Harv. L. Rev. 503, 534-538 (1991) (discussing Section 9(a)(2) and Congress's obsession at the time with speculator pools' "trade-based" manipulation). It was the artificial trades that were the heart of the speculator pools scheme, and thus the conduct targeted by Congress under Section 9(a)(2).

B. Nor Is There Liability For "Layering" Under Section 10(b) of the Exchange Act

Section 10(b) of the Exchange Act makes it "unlawful for any person . . . to use or employ . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe." 15 U.S.C. § 78j. While the SEC has adopted various rules and regulations that identify and prohibit specific "manipulative" acts, it has not adopted any rule prohibiting so-called "layering."[4]

Manipulation under Section 10(b) "refers generally to practices, such as wash sales, matched orders, or rigged prices that are intended to mislead investors by *artificially* affecting market activity." *Santa Fe Industries*, 430 U.S. at 476. The gravamen of manipulation is deception." *Gurary v. Winehouse*, 190 F.3d 37, 45 (2d Cir. 1999). "In identifying activity that is outside the 'natural interplay of supply and demand,' courts generally ask whether a transaction sends a false pricing signal to the market." *ATSI Communications v. Shaar Fund*, 493 F.3d 87, 100 (2d Cir. 2007) "The critical question then becomes what activity 'artificially' affects a security's price in a deceptive manner." *Id* at 100. "[T]he essential element of the [manipulation] claim is that *inaccurate* information is being injected into the marketplace." *GFL Advantage Fund v. Colkitt*, 272 F.3d 189, 205 (3d Cir. 2001) (emphasis in original).

Here, the open market orders placed by Avalon's traders are not deceptive and thus cannot be manipulative under Section 10(b). The orders are actual orders that convey the information that any legitimate order conveys – a willingness to buy or sell a certain quantity of securities at a certain price. That information was not inaccurate with regard to any of Avalon's traders' orders – if or when another market participant accepted Avalon trader's offer, the trader

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[4] While the SEC also alleges primary liability under Sections 17(a)(1) and (3) of the Securities Act, the language of those sections is nearly identical to Rule 10b-5(a) and (c) promulgated under Section 10b of the Exchange Act. *Compare* 15 U.S.C. § 77q(a)(1) and (3) *with* 17 C.F.R. 240.10b-5(a) and (c).

bought or sold the offered quantities of securities at the offered price. There was no artificiality; there was no deception. Unlike a fake wash trade between aligned parties, there was no false pricing or liquidity signal sent to the market. There was only a real order, conveying the true information that there was a real buyer or seller for a fixed quantity of securities at a fixed price. "The market is not misled when a transaction's terms are fully disclosed." *Wilson v. Merrill Lynch & Co.*, 671 F.3d 120, 130 (2d Cir. 2011).

For example, in *GFL Advantage Fund,* the plaintiff had provided $13 million in floorless convertible deft financing to the defendant. 272 F.3d at 195. Sometimes referred to as death spiral financing, plaintiffs' notes entitled it to collect the dollar value equivalent in shares of the Defendant's companies. *Id.* Plaintiff then engaged in a massive short selling campaign that defendant alleged artificially depressed the value of his companies' stock, which, in turn, enabled plaintiffs to demand more shares of stock to retire the same amount of debt. *Id* at 196-197. The Third Circuit ruled that the plaintiff's actions did not constitute manipulation because the trades were real trades with unaffiliated market participants that violated no rules or regulations:

> The fact that these short sales may have contributed to a decline in the stocks' prices is not evidence of deceptive or manipulative conduct, for there is no reason to believe that these prices were depressed artificially. Indeed, the district court stated it well when it wrote that it is unreasonable "to infer unlawful intent from lawful activity alone."

Id. at 207. The court concluded, that because "short selling, even in large volumes, is not in and of itself unlawful [it] therefore cannot be regarded as evidence of market manipulation. *Id.* at 209. In *ATSI Communications v. Shaar Fund,* the Second Circuit adopted the court's reasoning from *GFL Advantage Fund* in reaching the same conclusion in another death spiral case, holding: "To be actionable as a manipulative act, [open market transactions] must be willfully combined with something more to create a false impression of how market participants value a

security." 493 F.3d 87, 101 (2d Cir. 2007); *see also United States v. Mulheren*, 938 F.2d. 364, 368 (2d Cir. 1991) (expressing "misgivings about the government's view of the law" that otherwise legitimate "open market" transaction could constitute manipulation under Section 10(b)).[5]

In this case, like in the death spiral cases, there is nothing intrinsically unlawful about any of Avalon traders' orders. They violated no exchange rule, but rather were actual orders subject to actual execution by unaffiliated market participants. Because these legitimate orders were lawful, they cannot possibly constitute manipulative activity Section 10(b).

As noted in Avalon's prior memorandum, no Article III court has ever once determined that so-called "layering" constitutes a violation of the Exchange Act. In its Opp. Mem. at 6, the SEC misleadingly cites a Northern Illinois District Court case applying the criminal "spoofing"

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[5] The district court cases cited in the SEC's Opp. Mem. at 6 are inapposite. Judge Sand in *Nanopierce Techs v. Southridge Capital Mgmt.* endorsed and applied the framework from *GFL Advantage Fund* and *Mulheren* denying to dismiss manipulation claims only because the plaintiff had alleged "some other deceptive practice beyond mere [open market transactions]." No. 02-CIV-0767, 2002 WL 31819207, at *8 (S.D.N.Y. Oct. 10, 2002). The same court, in the same case, subsequently dismissed the defendant's manipulation counterclaim stating "courts, including this one, have hesitated to proceed on claims alleging only open-market trading without other fraudulent or deceptive activity." 2003 WL 21507294, at *9 (S.D.N.Y. June 30, 2003).

In re Initial Public Offering was decided 4 years before the Second Circuit decision in *ATSI Communications*, and its statements regarding the actionability of open market tractions contrary to circuit court's decision are effectively overturned. 241 F. Supp. 2d 281 (S.D.N.Y. 2003). While the decision in *SEC v. Marsi* was issued four months after *ATSI Communications*, Judge Holwell's ruling fails to cite or discuss the then recent Second Circuit opinion. 523 F. Supp. 2d 361 (S.D.N.Y. 2007). The *Marsi* court's holding that excessive short selling could constitute manipulation without "the something more" required by the court in *ATSI* Communications, directly contradicts the high court's ruling and should be ignored. *See, e.g. C.F.T.C. v. Amaranth Advisors*, 554 F. Supp. 2d 523, 537 (S.D.N.Y. 2008) (recognizing the conflict between *Masri* and *ATSI Communications*).

provision of the Commodities Exchange Act ("CEA").[6] *United States v. Coscia*, 177 F. Supp. 3d 1087, 1091 (N.D. Ill. 2016). As the SEC well knows, there is no such explicit "spoofing" prohibition under the Exchange Act, and no court has ever before endorsed the SEC's position that one should be inferred under Section 10(b).

Indeed, perhaps the most conclusive evidence of Congress' intent not to outlaw layering strategies under the Exchange Act, is the fact that Congress recently did make that conduct illegal solely in the commodities markets under the CEA. As part of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), Congress added two provisions to the CEA. The first, Section 6(c)(1), added to the CEA language that is virtually identical to the generic Exchange Act Section 10(b) manipulation language relied upon by the SEC – making it unlawful under the CEA to "employ . . . any manipulative or deceptive device or contrivance, in contravention of such rules and regulations as the Commission shall promulgate" 7 U.S.C. § 9(1); *compare* 15 U.S.C. § 78j (making it unlawful to "employ . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe.)"

In the same Dodd-Frank Act, Congress also amended Section 4c(a) of the CEA to make it "unlawful for any person to engage in any trading, practice, or conduct . . . that is of the character of, or is commonly known to the trade as 'spoofing' (bidding or offering with the intent to cancel the bid or offer before execution). 7 U.S.C. § 6c(a)(5)(c). As the SEC's expert, Professor

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[6] The SEC also misleadingly cites *In re Terrance Yoshikawa* as the supposed sole example of an SEC administrative decision endorsing "layering" as a violation of Section 10(b). Opp. Mem. at 6. However, that case "found that Yoshikawa had engaged in a practice called 'auto-execution manipulation'." SEC Release No. 53731, 2006 WL 1113518, at * 1 (April 26, 2006). The trades at issues in that case were not executed on the open market, but rather, internally by the defendant's broker and its dealer. There were no allegations of "layering" in that case, and the words "spoofing" or "layering" were never mentioned in the Commission's decision.

Hendershott, explains in his Report, what the SEC is currently calling “layering” is just a version of what CEA refers to as “spoofing.” Report at 6 n. 6 (“Layering is often used to refer to spoofing when multiple spoofing orders are used.”)

Congress did not believe that the language it borrowed from Section 10(b) of the Exchange, and currently relied upon by the SEC, prohibited “spoofing” or “layering.” Otherwise, it would not have also enacted Section 4(c)(a) to explicitly prohibit “spoofing” in commodities. *See Pennsylvania Dept. of Public Welfare v. Davenport*, 495 U.S. 552, 562 (1990) (expressing “deep reluctance” to interpret statutory provisions “so as to render superfluous other provisions in the same enactment.”) More importantly, when drafting and adopting Dodd-Frank, which made many changes to both the CEA and the Exchange Act, Congress saw fit to adopt an anti-spoofing provision in only the former and not the later. “Typically, the absence of statutory language indicates lack of intent.” *Securities Investor Protection Corp. v. Bernard L. Madoff Investment Services,* 496 B.R. 744, 754 (Bankr. S.D.N.Y. 2013), *aff'd sub no. In re Bernard Madoff Inv. Sec.*, 779 F.3d 74 (2d Cir. 2015). “Where Congress knows how to say something but chooses not to, its silence is controlling.” *In re Haas*, 48 F.3d 1153, 1156 (11th Cir. 1995). Here,

Congress was in the process of amending both the CEA and the Exchange Act and it chose not to prohibit spoofing/layering in the securities markets. This Court should infer Congressional intent that the Exchange Act *not* prohibit such conduct. *See Securities Investor Protection Corp. v. Bernard L Madoff Investment Services*, 496 B.R. at 754 (refusing to infer Congressional intent to allow interest damages under the SIPA, when Congress did not include explicit interest language found in other comparable federal statutes); *Simonoff v. Kaplan*, No. 10-civ-2923 LMM, 2010 WL 482359, at *7 (S.D.N.Y. Nov. 29, 2010) (holding that Congress

did not intend to regulate e-commerce under FACTA, given that Congress had explicitly included electronic transactions within the scope of other statutes).

Conclusion

The so-called "layering" conduct alleged by the SEC does not violate any federal security law. It cannot constitute manipulation because it entails only otherwise lawful trading that does not inject any false or deceptive information into the marketplace. Congress has not enacted any law and the SEC has not adopted any rule under the Exchange Act that prohibits such conduct. Thus, because it cannot show even and inference, much less a substantial likelihood that a securities law violation has occurred, the Court must deny the SEC's motion for preliminary injunctive relief.

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