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FBI joins SEC in computer trading probe

By Kara Scannell in New York

The FBI has joined securities regulators to tackle the potential threat of market manipulation posed by sophisticated computer trading strategies that have taken markets beyond the scope of traditional policing.

FBI agents have joined forces with a new unit within the Securities and Exchange Commission that examines hedge funds and other firms that are using algorithm trading strategies.

The SEC's Quantitative Analytics Unit is looking at abuses that might arise from the emergence of high-frequency trading firms and the use of dark pool (off exchange) trading. Traders using these methods can manipulate the market by flooding it with quotes, known as quote stuffing, or placing millions of orders that are quickly cancelled, to drive others to trade in ways that benefit their position, a practice known as layering.

Some of these trading strategies have been criticised of destabilising the market and putting retail investors at a disadvantage. Their supporters have said they increase liquidity in securities and reduce volatility.

The FBI has historically investigated cases of market manipulation, but people familiar with the matter said the collaboration with the SEC was an attempt to beef up the agency's expertise and catch up with fast-changing technology-driven trading strategies.

The move reflects market participants' evolution from traditional investment firms into financial engineering shops. Authorities are concerned that technological advances have outpaced hedge fund compliance programmes and left the stock market vulnerable to manipulation.

"If you don't speak the language, the specifics are already lost," said one person involved in the collaboration.

Authorities are exploring potential holes in the system, including new algorithms referred to as "news aggregation" that search the internet, news sites and social media for selected keywords, and fire off orders in milliseconds. The trades are so quick, often before the information is widely disseminated, that authorities are debating whether they violate insider trading rules, the people familiar with the matter said.

Authorities are also monitoring alpha capture systems, platforms where sell-side firms share information with buy-side professionals, for potential front running or insider trading. Also on their radar is artificial intelligence trading, an algorithm that predicts market reactions based on history.

One government official said market structure could be the next big area for cases, although it was not clear whether any of the strategies violated criminal laws. To prove a criminal case, the FBI would need to show that the trader intended to manipulate the stock, which could prove more difficult for strategies that are triggered by computers.

The SEC has brought a handful of cases involving these strategies and other investigations. No criminal case is on the horizon, one of the people said.

The FBI and SEC have successfully worked together in other areas, with their collaboration resulting in more than 80 prosecutions of insider trading over the past three and a half years.

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