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The Barclays dark pool scandal and its relevance to Australia

BestEx considers that legal action filed by the New York Attorney General against Barclays is only the tip of the iceberg. We believe that the fallout and penalties will dwarf those associated with the LIBOR rigging scandal. In this document we summarise the allegations and highlight the relevance of the case to the Australian market.

The Allegations

- The New York Attorney General has filed a lawsuit against Barclays accusing it of favouring high-speed traders and falsifying marketing materials to hide how much high-frequency traders were buying and selling in their dark pool. Similar action is likely to follow against other banks.

- The case against Barclays is that they deceived their own institutional clients to benefit their own high-frequency trading clients. The lawsuit alleges that Barclays promised to get the best possible prices for customers looking to buy or sell shares but instead took steps that maximized the bank's profits and executed nearly all of its customers' stock orders on its own dark pool instead of on exchanges or other venues that might have offered better prices.

- In particular, it is alleged that Barclays:

  - Made representations about its order routing practices that were false and misleading;
  - Operated its dark pool to favour HFT firms to the detriment of institutional clients; and,
  - Provided HFT firms with detailed information about the identity and trading activity of traditional investors in the pool.

- A former Director within the Equities Electronics Trading division at Barclays described the scheme as follows:

  - "[T]he way the deal would work is [Barclays] would invite the high frequency firms in. They would trade with the buy side. The buy side would pay the commissions. The high frequency firms would pay basically nothing… Barclays would make their money off the buy side. And the buy side would totally be taken advantage of because they got stuck with the bad trade…this happened over and over again."

Relevance to Australia

- ASIC Report 331 entitled Dark Liquidity and High-frequency Trading and published in March 2013 revealed that a number of Australian brokers were previously engaged in the types of activity for which Barclays are now being sued.

- A summary of the findings of the Dark Pool Taskforce (at Paragraph 11) included findings of 'potential conduct issues (around) misleading statements about crossing systems, failure to make disclosures to clients, representations about the regulation of crossing systems and conflicts of interest not adequately managed'.

- Paragraph 226 (for example) expanded further and is relevantly reproduced below:

Disclosure to clients

226 We are concerned about statements we have seen made to clients and to ASIC in relation to the nature of the liquidity in a crossing system or in relation to orders that can interact with other orders in a crossing system:

(a) Many crossing system operators have described their crossing system(s) to fund manager clients and to us as providing 'natural liquidity' or as having no high-frequency trading. Yet there are cases where there appears to be active facilitation, proprietary trading or high-frequency trading interacting with client orders. Some crossing system operators allow, or have previously allowed, access to their crossing systems by clients that the industry widely considers to be high-frequency traders while maintaining there is no high-frequency trading in their crossing system.

(b) Many crossing system operators are not disclosing where there is a market maker operating within their crossing system (or outside the crossing system but that interacts with orders after they have passed through the crossing system and before they reach the lit exchange market). For three market participants, at least, the market maker is the crossing system operator trading on its own behalf or that of a related body corporate.

- In November 2013 ASIC introduced a new Chapter 4A into its Market Integrity Rules which required brokers to publish information about the nature of the liquidity in their pools. The relevant ASIC website can be found here.

- While most brokers published deliberately vague information, the majority admitted to having HFT in their pools. Those parties included Credit Suisse, Deutsche Bank, JP Morgan, Merrill Lynch, Morgan Stanley and UBS. It is widely believed that Macquarie has HFT activity (in the form of facilitation or proprietary trading) in its pool though its disclosure simply states that 'clients of Macquarie are eligible to access' its dark pool. Goldman Sachs and Citigroup specifically claim not to have HFT in their dark pools.

- We are aware that certain brokers continue to promote their dark pool to clients as being among the largest, without disclosing that this is only because of the presence of HFT.

- It is not in the best interests of large investors to have their orders interacting with HFT in dark pools. As ASIC highlights at Paragraph 158, 'interaction with certain types of counterparties can affect execution quality, signal trading intentions and lead to adverse selection'.

- On the other hand, it is very much in the interests of brokers to execute client orders in their own dark pools instead of public markets. At Paragraph 195, ASIC states that 'market participants are incentivised to…match orders, including in their crossing systems, as it can reduce their transaction costs (through lower execution and reporting fees). These savings are a net benefit to the market participant because they are rarely, if ever, passed on to clients.'

- Accordingly, a conflict exists between the interests of brokers and their clients.

Worked Example
A fund manager's request to buy (or sell) shares is sent by their broker to its dark pool. A small portion of the order gets filled, typically with an HFT firm on the other side. The HFT firm thereby becomes alert to the presence of an institutional buyer or seller and immediately acts on that information by adjusting their orders on the lit ASX and Chi-X markets. By the time the client order arrives at the lit ASX or Chi-X markets, the market looks quite different to the time at which the client placed the order with their broker and tried to hit the bid or offer. All of this happens in much less time than the blink of an eye. The fund manager either misses out altogether or is forced to pay a higher price to buy the shares (from the HFT firm who has already bought and is now a seller at the higher price). The fund manager is left scratching their head as to what happened to the shares that they had just seen sitting on the bid or offer in the market and had tried to hit. All the while, the fund manager is oblivious to the fact that the entire scenario has been caused by their broker's order routing decision and could have been completely avoided by taking the order routing decision into their own hands.

- Despite the mandatory disclosures, many domestic fund managers, particularly at the boutique end, have failed to address the way their orders are being routed. Instead, they continue to leave the order routing decision to their brokers, placing misplaced trust in the broker to do the right thing by them. Inevitably, and often unbeknownst to the fund manager, their orders are sent to the brokers dark pool where they interact with HFT. As the former Barclays executive describes it, the fund manager gets 'stuck with the bad trade…over and over again'.

- BestEx believes that fund managers could face legal action from investors for ignoring the order routing practices of their brokers. It would be wrong, for example, for a fund manager to assume that they have satisfied their fiduciary obligations to investors by placing orders with brokers and turning a blind eye to what happens next. How can a fund manager justify having allowed their broker to route orders into a toxic dark pool instead of public markets and having cost their investors millions of dollars as a result?

- The only way for investors to avoid mistreatment is to carefully analyse the performance of their brokers to make sure they are being treated fairly. As a minimum, fund managers should take the following steps:

    - Execute through firms that demonstrate a preparedness to place the interests of their clients ahead of their own;
    - Request their brokers to turn off interaction with all non-natural and predatory counterparties in their dark pools;
    - Ensure brokers provide detailed reports that show a breakdown of the trading venues used to execute their orders and the justification for these decisions. Also seek clarification on the venues on which their brokers have attempted execution;
    - Instruct brokers to apply Minimum Execution Quantities when executing orders in their dark pools. This will avoid interactions with HFT; and,
    - Opt out if not satisfied that routing to a broker's dark pool is in their best interests.

About BestEx

BestEx is a trade execution firm that was founded in 2012 to provide fund managers with fair and transparent trade execution. It is broker neutral and venue neutral and operates on an agency only basis. As it does not face any of the conflicts that confront brokers in multi-market environments, BestEx can focus exclusively on executing orders with the best possible outcomes for clients, allowing them to deliver superior returns to their investors. BestEx has offices in Sydney and Melbourne.

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