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New York Attorney General Alleges Fraud Against Barclays Over "Dark Pool"

New York's Attorney General has filed a civil fraud lawsuit against Barclays PLC and a subsidiary ("Barclays") over their operation of a private securities trading venue known as a "dark pool." Dark pools are supposed to benefit institutional investors by allowing them to trade large blocks of securities without the disadvantages their trades may encounter on public exchanges, especially the problems posed by high frequency traders with faster access to market data on those exchanges. Both dark pools and high frequency trading have come under increased scrutiny by Congress and regulators. In this latest development, the Attorney General's suit alleges that Barclays deceived institutional clients about the nature and extent of high frequency trading in its dark pool while providing advantages to high frequency traders using it. The alleged conduct, if true, would frustrate one of the main benefits of dark pools, and would suggest that even sophisticated investors may be kept in the dark about the execution and fairness of their trades. Dark pool subscribers and other investors may have suffered damages as a result and may have actionable claims.

Unlike public exchanges, which display pending orders to all market participants, dark pool trading is supposed to be opaque, with neither the size of the trade nor the identity of the trader revealed until the order is filled. Dark pools thus allow institutional investors like mutual funds to buy or sell large blocks of securities without risking the adverse impact that public knowledge of the order could have on the market price. High frequency traders seek "informational leakage" that allows them to trade ahead of an anticipated stock purchase, and the faster data access they are given on public exchanges can create such leakage which they can exploit to the detriment of others on the exchanges. Dark pools can protect institutional investors from the information advantage that high frequency trading firms enjoy on public exchanges. Or so it seemed with respect to the Barclays dark pool.

The Attorney General alleges that beginning in 2011, Barclays sought to increase the market share of its dark pool and make it the largest in the United States. To encourage institutional investors to use the pool, Barclays allegedly falsified marketing materials about the extent and type of high frequency trading in its dark pool. For instance, it is alleged to have intentionally excluded from those materials data concerning the pool's then-largest participant, a high frequency trader known by Barclays to engage in predatory behavior, and understated the level of aggressive trading activity in the pool. The lawsuit alleges that Barclays also claimed to use special safeguards to protect its institutional clients from "aggressive," "predatory," or "toxic" high frequency traders, but that those mechanisms were ineffective and were at times overridden by Barclays when they flagged predatory trading.

In essence, the Attorney General alleges that Barclays operated its dark pool in a manner that favored high frequency traders. The lawsuit asserts that Barclays actively sought to attract high frequency traders to its dark pool by secretly providing them advantages over other traders in the pool, including information about the identity and activity of the other traders. Such information would allow high frequency traders to maximize the effectiveness of their aggressive strategies in the dark pool – but would create for institutional clients the same disadvantages they sought to escape by using the pool. Barclays also allegedly told its brokerage clients that their orders were routed to particular trading venues based solely on execution quality when, in reality, all client orders were first routed to the Barclays dark pool. The complaint seeks disgorgement of monies obtained as a result of the alleged fraud, restitution, damages, and injunctive relief.

The Attorney General's complaint against Barclays comes on the heels of SEC charges against another dark pool operator, Liquidnet Inc., which allegedly misused confidential information about its customers' buy and sell intentions in an effort to expand its business and find additional sources of liquidity for its dark pool. (In April, alleged practices relating to high frequency trading spawned a class action against major exchanges, trading platforms, brokerage firms, banks, and high frequency trading firms.) The allegations against Barclays and Liquidnet suggest that if pool operators are engaged in wrongdoing, dark pools may not be as dark as they seem. Time will tell whether the misconduct alleged against Barclays and Liquidnet is isolated, or whether other dark pools may be implicated in alleged wrongdoing.

For further information please contact:

Mark Leimkuhler at mark.leimkuhler@lewisbaach.com or +1.202.659.7204
Jack Gordon at jack.gordon@lewisbaach.com or +1.202.659.7975