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Dark Pools

Misrepresentations About Dark Pool Participants and Order Routing Cost Citi Entities Nearly $13 Million in Recent SEC Settlement

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By Charlie Marlow, *Hedge Fund Law Report*

In another illustration of why fund managers must conduct careful due diligence of their counterparties, the SEC recently settled charges against Citigroup Global Markets, Inc. (CGMI) and Citi Order Routing and Execution, LLC (CORE). The SEC alleged that CGMI falsely claimed that the dark pool it marketed did not admit high-frequency traders and hid from customers that about half of all executions through the dark pool were routed to external venues. In addition, CORE, which operated the pool, allegedly functioned as an unregistered exchange. This article details the respondents' alleged misconduct and the terms of the settlement order (Order).

In the press release announcing the settlement, Joseph G. Sansone, Chief of the Market Abuse Unit of the SEC Division of Enforcement, said, "Market participants deserve to make informed decisions about where they execute their orders. All trading venues, regardless of their trade volume, must ensure that their users have accurate information, particularly about key issues like order routing."

For another SEC action against CGMI, see "Failure by Investment Advisers to Ensure Accurate Client Billing May Lead to SEC Enforcement Action and Penalties" (Feb. 2, 2017).

Respondents' Operation of Citi Match

CGMI and CORE are indirect wholly owned subsidiaries of Citigroup, Inc. and are registered with the SEC as broker-dealers.

CORE, formerly known as Automated Trading Desk Financial Services, LLC, operated as an equity market maker from 2006 through 2016. In 2007, it established a separate order-matching service for institutional users distinct from its market-making business. After Citigroup acquired CORE later that year, it renamed the service "Citi Match." CGMI was responsible for marketing and sales of Citi Match and CORE was responsible for operating it.

According to the Order, CGMI marketed Citi Match exclusively to institutional customers as a dark pool with the following features:

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- Citi Match orders could never be matched against orders placed by CORE in its market-making capacity.
- The pool offered "premium liquidity" and "purity" to participants.
- Participants' orders could interact with other institutional orders, as well as retail orders and "immediate-or-cancel" (IOC) orders from other broker-dealers not yet exposed to CORE as market maker.
- The target commission rate of 1 cent per share was substantially higher than the rate charged by other dark pools on the basis that the pool was "exclusive," was "premium" and – of particular relevance to the enforcement action – did not accept high-frequency trading (HFT).

Regulators have been concerned with whether dark pool operators accurately describe how their pools operate. See "Regulators From the SEC, CFTC and New York Attorney General's Office Reveal Top Hedge Fund Enforcement Priorities (Part Two of Four)" (Dec. 18, 2014).

Misrepresentations Regarding High-Frequency Trading

CGMI allegedly represented to investors in marketing materials, presentations, questionnaire responses and emails that HFT firms were not permitted to use Citi Match. According to the SEC, CGMI repeatedly referred to "HFT" in those materials, but it "did not adopt a definition of 'HFT' with respect to Citi Match or tell users how it defined 'HFT.'" One such presentation said "No High Frequency Flow," and at least 16 responses to investor questions indicated that HFT firms were not permitted to rest orders on Citi Match.

A footnote in the Order also asserted that "CGMI did not establish policies and procedures designed specifically to identify and prevent HFT use of Citi Match during the relevant period." The SEC did not, however, charge CGMI on that basis. For an enforcement action against CGMI alleging compliance failures, see "Failure to Regularly Audit Compliance and Surveillance Systems May Carry Significant Consequences" (Aug. 27, 2015).

The SEC claimed that, at various times from 2010 through 2014, CGMI permitted "two proprietary trading firms that can reasonably be considered high frequency trading firms" to trade on Citi Match. To support that assertion, the SEC noted that at least nine different employees of the respondents referred to those firms in internal correspondence as "HFT" or "HFT-like."

One of those firms traded about 140 million shares, with a total notional value of approximately $7.9 billion, with other Citi Match institutional users. The other traded about 72 million shares, with a notional value of approximately $1.5 billion. According to the Order, those firms were "among the most active users" of the system, accounting for more than 17 percent of all executions by dollar volume that Citi Match did not route externally.

See our three-part series on mitigating prime broker risk: "Preliminary Considerations When Selecting Firms and Brokerage Arrangements" (Dec. 1, 2016); "Structural Considerations of Multi-Prime or Split Custodian-Broker Arrangements" (Dec. 8, 2016); and "Legal Considerations When Negotiating Prime Brokerage Agreements" (Dec. 15, 2016).

Misrepresentations Regarding External Routing of Trades

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Until August 1, 2014, if an order placed on Citi Match was not immediately executed, the order would continue to rest on Citi Match, but the system would also simultaneously place copies of the order on a number of external trading venues. The orders could be placed as IOC orders, resting orders or both. If an order found a match on one of those external venues, the order would execute there.

Citi Match routed orders to more than 20 external venues, including alternative trading systems (ATSs) that did not offer the claimed "premium" features of Citi Match and that charged significantly less for executions, national securities exchanges and electronic market makers. Some of those venues had HFT participants.

In 2012 and 2014, more than half of the executions, by dollar volume, on Citi Match took place on external venues. In 2013, more than one-third were executed on external venues. The Order indicates that orders for about 9 billion shares, with a notional value of more than $300 billion, were routed to, and executed on, external venues.

CGMI charged Citi Match users the full Citi Match commission on all externally routed orders, even when the external venues charged less.

Trade routing, and use of an ATS, may raise best execution issues. See "ACA Panel Reviews Rules Related to Aggregation of Publicly Traded Securities, Best Execution, Soft Dollars, Portfolio Holding Liquidity and Gifts (Part Two of Two)" (Sep. 13, 2018).

Marketing Materials

The SEC alleged that "CGMI did not adequately disclose to all Citi Match users that external routing was a default feature of the dark pool." Its marketing materials, technical specifications and other documents did not mention external routing. When users asked specifically about external routing, CGMI allegedly provided inconsistent responses. In those instances, it "generally disclosed" that orders could be routed as IOC orders. In only a few instances did it disclose that it routed both IOC and resting orders.

Trade Reporting

CGMI used the Financial Information eXchange protocol (FIX) to communicate trade information with Citi Match users. Prior to June 2012, CORE did not enable a FIX field, known as "Tag 30," that identified the venue where a trade was executed. If a user asked for Tag 30 to be enabled, the tag always identified Citi Match as the venue, even when a trade had been routed and executed externally.

After June 2012, CORE enabled Tag 30 for Citi Match users. Unless the user specifically asked CORE to identify the external venues on which trades were executed, however, Tag 30 would always show Citi Match as the execution venue, even when a trade executed on an external venue.

In June 2014, CGMI began using a frequently asked questions document that, from the SEC's perspective, adequately "described both forms of external routing and provided a list of the default venues to which orders were routed."

Citi Cross

Commencing in early 2012, Citi Match began routing trades to "Citi Cross," a different dark pool operated by CGMI that accepted HFT and that charged "substantially less" than Citi Match for

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executions. By 2013, more than half of all externally routed trades on Citi Match were routed through Citi Cross. In total, about 3 billion shares, with a notional value of $115 billion, were routed away from Citi Match and executed on Citi Cross. As it did when routing trades to other external venues, Citi Match charged users the full Citi Match commission for trades executed on Citi Cross.

For a similar recent SEC enforcement action, see "$42-Million Enforcement Action Against Merrill Lynch Reminds Fund Managers to Probe Where Broker-Dealers Are Routing Their Trades" (Aug. 2, 2018).

CORE Was an Unregistered Exchange

According to the SEC, "CORE operated as an exchange by virtue of providing Citi Match as a marketplace for [National Market System] stocks." It fell within the definition of "exchange" set forth in Section 3(a)(1) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 3b-16(a) thereunder and did not fit within any of the available exemptions due to the following:

- Multiple buyers and sellers, including broker-dealers and institutional investors, entered orders into Citi Match.
- Those orders could "rest in Citi Match or interact and automatically execute pursuant to pre-programmed priority rules and procedures" that did not involve the exercise of discretion by CORE as a market maker.
- Citi Match was not "incidental" to CORE's market making business. It was "intentionally designed, operated, and marketed as a separate pool for institutional users," where orders could never match with CORE as a market maker. From 2011 through 2015, more than 7 billion shares traded on Citi Match.
- It did not satisfy Exchange Act Rule 3a1-1(a)(2) or Regulation ATS, which provide an exemption from registration for certain ATSs.

See "Six Steps That Hedge Fund Managers Should Take to Protect Their Confidential Information When Using or Evaluating Dark Pools" (Oct. 18, 2012).

Specific Violations and Sanctions

By making material misrepresentations about use of Citi Match by HFT firms and its routing of trades to external venues, CGMI allegedly violated Section 17(a)(2) of the Securities Act of 1933 (Securities Act), which makes it unlawful to obtain money or property by means of any untrue statement or omission of a material fact in a securities offering.

By operating Citi Match, CORE allegedly violated Section 5 of the Exchange Act, which makes it unlawful to effect securities transactions on an exchange unless the exchange is registered as a national securities exchange or an exemption from registration applies.

Without admitting or denying the SEC's allegations, CGMI agreed to:

- cease and desist from violating Section 17(a)(2) of the Securities Act;
- accept a censure;
- pay disgorgement of $4,718,784.59 and prejudgment interest of $718,690.47; and
- pay a civil penalty of $6.5 million.

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CORE agreed to:

- cease and desist from violating Section 5 of the Exchange Act;
- accept a censure; and
- pay a civil penalty in the amount of $1 million.

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