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UBS Dark Pool Leads to $14.5 Million in Settlement Paid to SEC

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Dark pools are private exchanges or forums for trading securities that primarily facilitate large block trades by institutional investors. Dark pools offer the efficiency (in the form of liquidity) of trading on a public exchange, but allow the transactions to remain secret—neither the price nor the identity of the firm is disclosed—until the trade is filled. The lack of transparency in dark pool trades allows large trades to be made by institutional investors without influencing the market and adversely affecting the price. Private banks and brokerages generally operate dark pools, which are subject to more relaxed public disclosure requirements than public exchanges. But that is not to say that dark pools are not subject to federal securities laws, as evidenced by the SEC investigation of and charges brought against Swiss banking-giant UBS.

According to the SEC complaint, UBS is the owner and operator of UBS ATS, an alternative trading system ("ATS") commonly referred to as a "dark pool." UBS ATS is a private execution venue that accepts, matches, and executes orders to buy and sell securities that it receives from UBS clients and UBS ATS subscribers. Recently, UBS agreed to pay $14.5 million to the SEC in a settlement for conduct allegedly in violation of Rule 612 of Regulation NMS arising out of operation of its dark pool. The UBS dark pool (known as PPP, or PrimaryPeg-Plus) ranked trade orders in increments smaller than one cent, and provided priority to certain orders based on this otherwise-insignificant, sub-penny difference. According to the SEC, high-frequency trading (HFT) firms have the ability to jump ahead of the market under the PPP system by placing orders at a fractionally higher price or selling at a fractionally lower price. The SEC further alleged that UBS then withheld information about this order type from all but its most valued institutional investors, often HFTs, allowing the more favored traders to gain execution priority over other market participants.

The vulnerability of dark pools to predatory trading by HFTs, which is made possible by the lack of transparency inherent in dark pool trades, is a primary concern of the SEC. In his 2014 New York Times Best Seller, Flash Boys, Michael Lewis illuminates the concerns associated with predatory HFT practices and cautions against large dark pools, such as the UBS ATS, as venues where such practices can be the most harmful to the market. The UBS ATS was the largest equity dark pool in the US during the second quarter of 2014. During that period, it executed over $416 billion in equity securities transactions. One source indicates that in 2014 nearly 15% of all US trade volume was done on off-exchange forums like the UBS dark pool.